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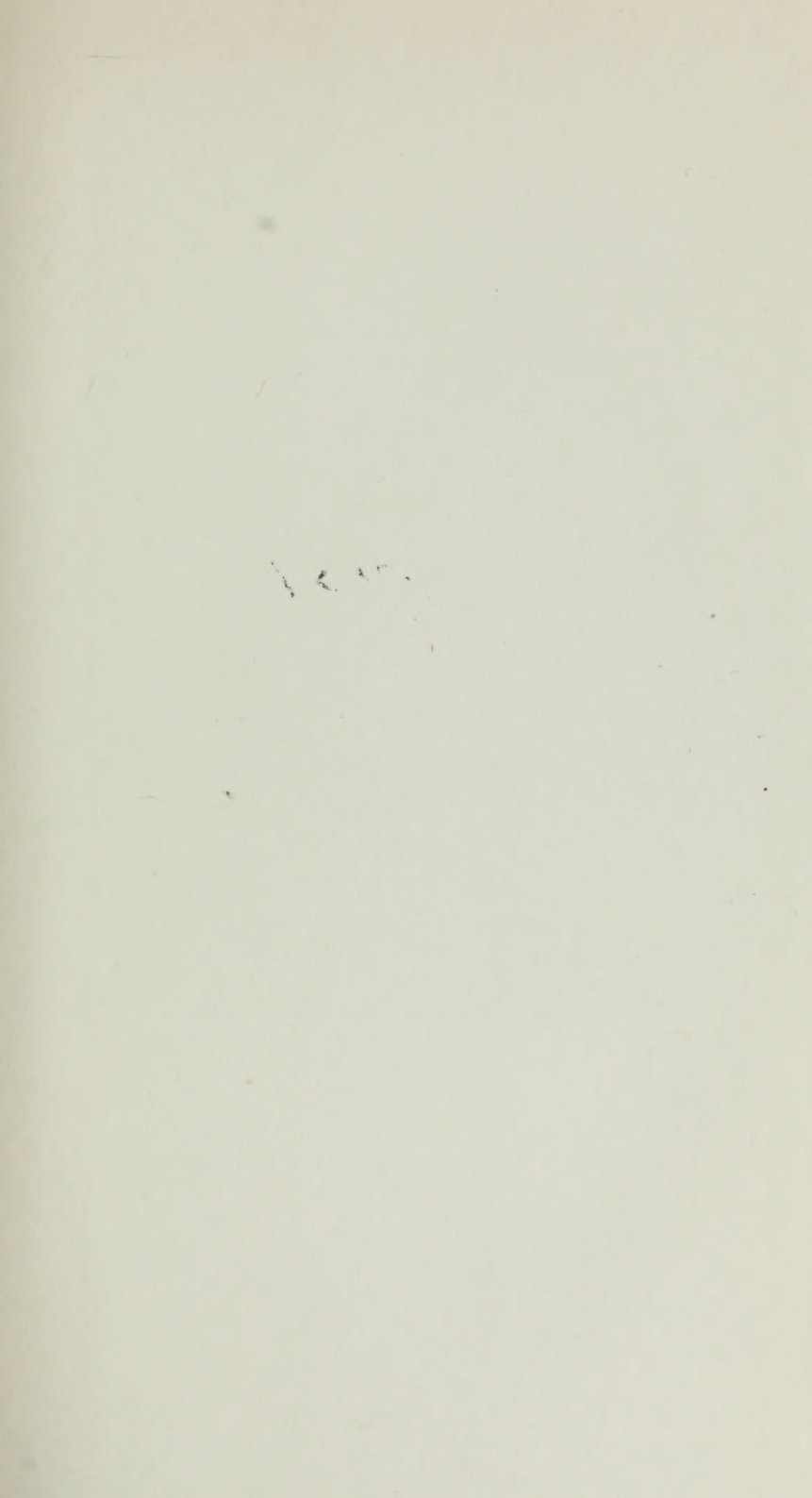
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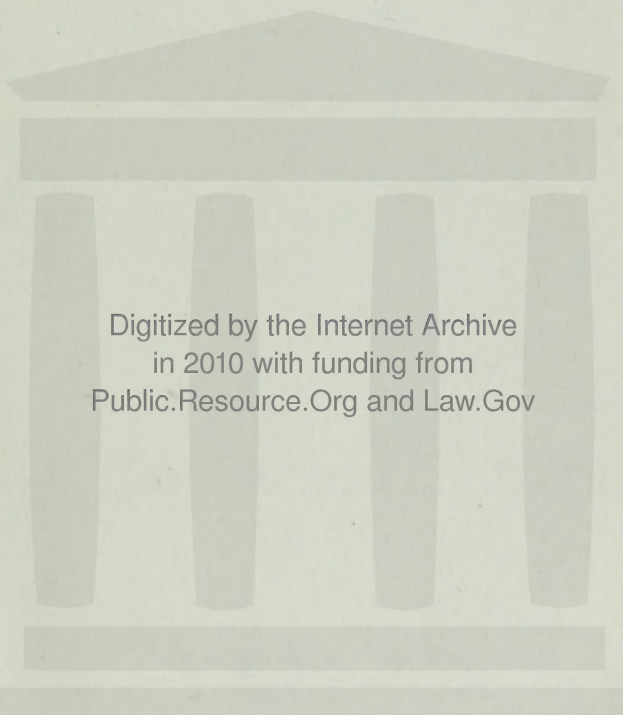
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No. 12659

2657

United States
Court of Appeals
for the Ninth Circuit.

EDWARD D. COFFEY,

Appellant,

VS.

ANTONIO POLIMENI,

Appellee.

Transcript of Record

Appeal from the District Court,
Territory of Alaska,
Third Division

FILED

NOV 24 1950

PAUL P. O'BRIEN,
CLERK

No. 12659

United States
Court of Appeals
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EDWARD D. COFFEY,

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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

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NAMES AND ADDRESSES OF ATTORNEYS

Attorneys for Plaintiff:

McCUTCHEON & NESBETT,

Box 2392,

Anchorage, Alaska.

Attorneys for Defendant:

DAVIS & RENFREW,

Box 477,

Anchorage, Alaska.

In the District Court for the Territory of Alaska,
Third Division

No. A5366

ANTONIO POLIMENI,

Plaintiff,

vs.

EDWARD D. COFFEY,

Defendant.

COMPLAINT

The plaintiff complains of defendant and alleges:

I.

That at all times herein mentioned the plaintiff was the owner and proprietor of a restaurant in south Naknek, Third Division, Territory of Alaska, said restaurant consisting of a main building and two auxiliary buildings completely furnished and equipped and with stocks of merchandise, all with the reasonable value of Ten Thousand Dollars (\$10,000.00).

II.

That at all times herein mentioned the defendant was, and now is, engaged in the business of a general insurance agent in the City of Anchorage, Third Division, Territory of Alaska.

III.

That on the 30th day of March, 1948, plaintiff applied to defendant by letter for insurance against loss or damage by fire upon the above-described

property, and defendant, on the 9th day of April, 1948, acknowledged that application by letter and requested a description of the said property, promising plaintiff upon receipt thereof, to supply the insurance desired by plaintiff.

IV.

That in compliance with defendant's request, plaintiff, on the 17th day of April, 1948, forwarded to the defendant by letter, all of the information requested by defendant in his letter of April 9, 1948, and all information necessary to the placement of the insurance desired by plaintiff in the total amount of Ten Thousand Dollars (\$10,000.00), a copy of said letter being attached hereto, marked Exhibit "A," and made a part hereof.

V.

That the defendant received plaintiff's letter of April 17, 1948, in due course of post, but through negligence lost or misplaced same, and by reason of said negligence failed to insure plaintiff's property against loss by fire by policies of insurance in the usual form issued by defendant.

VI.

That the insurance companies represented by the defendant, by policies of insurance in the usual form issued by defendant, among other things, promise and agree to make good to the insured all such immediate loss or damage, not exceeding in amount the sum insured, as shall happen by fire to the property insured.

VII.

That on or about the 20th day of July, 1948, all of the property described in paragraph I except the two auxiliary buildings was totally destroyed by fire and that, at the time of said destruction, said property was of a value in excess of the sum of Ten Thousand Dollars (\$10,000.00).

VIII.

That plaintiff at all times mentioned herein stood ready, able and willing to pay to defendant any premium moneys requested by defendant in consideration of the issuance of the policies of fire insurance requested by plaintiff and promised by defendant.

IX.

That plaintiff, during the times mentioned herein, made no attempt to procure fire insurance from any insurance agent other than defendant, and at the time of destruction of plaintiff's property there was no insurance coverage thereon.

X.

That by reason of the negligence of defendant as aforesaid, plaintiff has sustained personal loss in the sum of Ten Thousand Dollars (\$10,000.00).

And for a Separate and Second Cause of Action
Against Defendant Plaintiff Alleges:

I.

Realleges all of the allegations contained in paragraphs I, II, III, and IV of plaintiff's complaint herein.

II.

That the defendant received plaintiff's letter of April 17, 1948, in due course of post but failed, in breach of his promise, to insure plaintiff's property against loss by fire by policies of insurance in the usual form issued by defendant.

III.

That plaintiff at all times herein mentioned stood ready, able and willing to pay to defendant any premium requested by defendant in consideration of the issuance of the policies of fire insurance requested by plaintiff as promised by defendant.

IV.

That the insurance companies represented by defendant, by policies of insurance in the usual form issued by defendant, among other things, promise and agree to make good to the insured all such immediate loss or damage, not exceeding in amount the sum insured, as shall happen by fire to the property insured.

V.

That on or about the 20th day of July, 1948, all of the property described in paragraph I of plaintiff's complaint except the two auxiliary buildings was totally destroyed by fire, and that, at the time of said destruction, said property was in excess of the sum of Ten Thousand Dollars (\$10,000.00).

VI.

That plaintiff, during the times mentioned herein, had made no attempt to procure fire insurance from

any insurance agent other than defendant, and at the time of destruction of the plaintiff's property there was no insurance coverage thereon.

Wherefore, plaintiff prays judgment against defendant in the sum of Ten Thousand Dollars (\$10,000.00), his cost of suit, plus a reasonable sum as allowance for attorney's fees.

McCUTCHEON & NESBETT,

By /s/ BUELL A. NESBETT.

United States of America,
Territory of Alaska—ss.

Antonio Polimeni, being first duly sworn on oath deposes and says: That he is the plaintiff in the above-entitled action; that he has read the foregoing complaint, knows the contents thereof, and that the same is true as he verily believes.

/s/ ANTONIO POLIMENI.

Subscribed and sworn to this 23rd day of December, 1948, before me.

[Seal] /s/ SHELLE W. BROOKS,
Notary Public in and for
Alaska.

My Commission expires: 2/3/52.

[Exhibit A attached is identical to Plaintiff's Exhibit No. 3 set out at page ——.]

[Endorsed]: Filed February 11, 1949.

[Title of District Court and Cause.]

ANSWER

Comes now Edward D. Coffey, the above-named defendant, and by way of answer to the First Cause of Action of plaintiff's Complaint, admits, denies and alleges as follows:

I.

Defendant has no knowledge or information sufficient to form a belief concerning the allegations of Paragraph I of the First Cause of Action of plaintiff's Complaint, and therefore denies each and all of such allegations.

II.

Defendant admits that at the times mentioned in plaintiff's Complaint, defendant was and now is engaged as an insurance agent and broker in the City of Anchorage, Third Division, Territory of Alaska, and denies the other allegations of Paragraph II of the First Cause of Action of plaintiff's Complaint.

III.

Defendant denies each and all the allegations of Paragraph III of the First Cause of Action of plaintiff's Complaint, except that defendant admits that under date of March 30, 1948, plaintiff requested information of the defendant concerning certain insurance, and that on the 9th day of April, 1948, defendant by letter acknowledged receipt of the inquiry made by plaintiff under date of March 30, 1948, and furnished certain information requested in that inquiry.

IV.

Defendant admits that on or about the 17th day of April, 1948, plaintiff mailed a letter to defendant; that a copy of such letter is attached to plaintiff's Complaint, marked Exhibit "A," but denies each and all the other allegations of Paragraph IV of the First Cause of Action of plaintiff's Complaint.

V.

Defendant admits that he received plaintiff's letter dated April 17, 1948, a copy of which is attached to plaintiff's Complaint as Exhibit "A," in due course of post, and denies each and all the other allegations of Paragraph V of the First Cause of Action of plaintiff's Complaint.

VI.

Defendant admits the allegations of Paragraph VI of the First Cause of Action of plaintiff's Complaint, subject, however, to the conditions, exceptions and exclusions of such policies.

VII.

Defendant has no knowledge or information sufficient to form a belief concerning the allegations of Paragraph VII of the First Cause of Action of Plaintiff's Complaint, and therefore denies each and all of such allegations.

VIII.

Defendant has no knowledge or information sufficient to form a belief concerning the allegations of Paragraph VIII of the First Cause of Action of

plaintiff's Complaint, and for that reason denies each and all of such allegations, except the allegation that defendant promised to furnish plaintiff any insurance, and that allegation is specifically denied. In that connection defendant alleges that plaintiff at no time offered or tendered any insurance premium in any amount to defendant in connection with the policy of insurance plaintiff claims to have ordered from defendant, and alleges that defendant did not at any time promise or agree to furnish any insurance in any amount to the plaintiff in connection with the property of the plaintiff above mentioned.

IX.

Defendant has no knowledge or information sufficient to form a belief concerning the allegations of Paragraph IX of the First Cause of Action of plaintiff's Complaint, and therefore denies each and all of such allegations.

X.

Defendant denies each and all the allegations of Paragraph X of the First Cause of Action of plaintiff's Complaint, and in that connection alleges that if in fact plaintiff has sustained personal loss in the sum of \$10,000.00, or in any other sum, that such loss was not due to any negligence of the defendant, and that defendant is not liable to plaintiff therefor. That if in fact plaintiff suffered any damages, defendant alleges that said resulting damages were not the result of any negligence or carelessness of the defendant, but were the result of carelessness

and negligence of the plaintiff by his failure to act on the information received in the letter of June 4 (Exhibit 5 attached hereto) without the use by plaintiff of due care and circumspection for his own protection.

By way of answer to the Second Cause of Action of plaintiff's Complaint, defendant admits, denies and alleges as follows:

I.

Defendant adopts his answers to Paragraphs I, II, III and IV of the First Cause of Action of plaintiff's Complaint as and for his answer to Paragraph I of the Second Cause of Action of plaintiff's Complaint, to the same extent as though such answers were here re-alleged in full.

II.

Defendant admits that he received plaintiff's letter of April 17, 1948, in due course of post, and denies each and all the other allegations of Paragraph II of plaintiff's Second Cause of Action. In that connection defendant alleges that he never at any time promised to insure plaintiff's property against loss by fire by policies of insurance in the usual form issued by defendant, or otherwise, and defendant alleges that he is not engaged and has never been engaged in issuing insurance policies except insofar as defendant in the course of his business acts as agent for companies authorized to write insurance in the Territory of Alaska.

III.

Defendant has no knowledge or information sufficient to form a belief concerning the allegations of Paragraph III of the Second Cause of Action of plaintiff's Complaint, and therefore denies each and all of such allegations, except that defendant specifically denies that he ever promised to issue a policy of insurance to the plaintiff in connection with the property described in plaintiff's Complaint.

IV.

Defendant admits the allegations of Paragraph IV of the Second Cause of Action of plaintiff's Complaint, subject, however, to the conditions, exceptions and exclusions of the policies in question.

V.

Defendant has no knowledge or information sufficient to form a belief concerning the allegations of Paragraph V of the Second Cause of Action of plaintiff's Complaint, and therefore denies each and all of such allegations.

VI.

Defendant has no knowledge or information sufficient to form a belief concerning the allegations of Paragraph VI of the Second Cause of Action of plaintiff's Complaint, and therefore denies each and all of such allegations.

As a further answer to plaintiff's Complaint, and by way of affirmative defense thereto, defendant alleges as follows:

I.

That the entire negotiation between plaintiff and defendant concerning proposed insurance on property claimed by plaintiff to be owned by him and described in plaintiff's Complaint, was had by correspondence between the parties. That attached hereto and by reference made a part hereof are copies of the entire correspondence between plaintiff and defendant concerning the matter here at issue, as follows:

Exhibit 1, letter dated March 30, 1948, directed to defendant Edward D. Coffey, at Anchorage, Alaska, and signed Antonio Polimeni.

Exhibit 2, letter dated April 9, 1948, addressed to Mr. Antonio Polimeni, South Naknek, Alaska, and signed by Grace McConnell on behalf of defendant.

Exhibit 3, letter dated April 17, 1948, addressed to the defendant Edward D. Coffey, at Anchorage, Alaska, signed by Antonio Polimeni. (This letter is the same as Exhibit "A" attached to plaintiff's Complaint.)

Exhibit 4, letter dated June 1, 1948, addressed to Edward Coffey, Anchorage, Alaska, signed by Antonio Polimeni.

Exhibit 5, letter dated June 4, 1948, addressed to Mr. Antonio Polimeni, at South Naknek, Alaska, signed by Evelyn McCord on behalf of defendant.

Exhibit 6, letter dated July 23, 1948, addressed to Mr. Antonio Polimeni, South Naknek, Alaska, signed by Grace McConnell on behalf of the defendant.

Exhibit 7, letter dated August 2, 1948, addressed to Edward D. Coffey, General Insurance, Anchorage, Alaska, signed by Hal M. Marchbanks, United States Commissioner.

Exhibit 8, telegram dated August 5, 1948, addressed to Hal M. Marchbanks, United States Commissioner, Naknek, Alaska, signed by Edward D. Coffey.

Exhibit 9, letter dated August 5, 1948, addressed to Mr. Antonio Polimeni, South Naknek, Alaska, signed by Grace McConnell on behalf of the defendant.

II.

That as will appear from the correspondence attached hereto as exhibits, and more particularly described in Paragraph I above, there was no meeting of the minds of the parties and no contract resulted between the parties, and if in fact plaintiff owned certain property, as alleged in his Complaint, and if in fact such property was destroyed by fire, defendant has no liability to plaintiff by reason of such destruction.

Wherefore, having fully answered plaintiff's Complaint, defendant prays that plaintiff take nothing thereby, and that defendant have and recover of and from the plaintiff defendant's costs and disbursements in this action incurred, including

a reasonable attorney's fee to be fixed by the Court.

DAVIS & RENFREW,

Attorneys for Defendant,

By /s/ EDWARD V. DAVIS.

United States of America,

Territory of Alaska—ss.

Edward D. Coffey, being first duly sworn, on oath deposes and says:

That he is the defendant above named; that he has read the foregoing Answer, knows the contents thereof, and that the matters and things therein contained are true as he verily believes.

/s/ EDWARD D. COFFEY.

Subscribed and sworn to before me this 26th day of May, 1949.

[Seal] /s/ EDWARD V. DAVIS,

Notary Public for Alaska.

My Commission expires: 11/7/1950.

[Exhibits attached numbered 1 through 9 and are identical to Plaintiff's Exhibits numbered 1 through 9 and are set out at pages 166 to 175, save and except Form Number 7080 which is a part of Exhibit 2 and is set out as Defendant's Exhibit B at page 274.]

Receipt of Copy acknowledged.

[Endorsed]: Filed May 26, 1949.

[Title of District Court and Cause.]

MOTION FOR BILL OF PARTICULARS

Comes now Edward D. Coffey, the above-named defendant, by and through Davis & Renfrew, his attorneys, and moves that plaintiff may be required to furnish a bill of particulars as follows:

1. That the plaintiff be required to describe with particularity the buildings described in Paragraph I of the First Cause of Action of plaintiff's Complaint.

2. That plaintiff be required to set forth with particularity a full and complete description of the furnishings and equipment contained in such buildings, and to set forth what furnishings and equipment were contained in each of the several buildings.

3. That defendant be required to furnish an inventory of the stocks of merchandise claimed by plaintiff in Paragraph I of his First Cause of Action to have been contained in the buildings therein described, setting forth what merchandise was located in each of such buildings.

4. That plaintiff be required to furnish full and complete particulars as to the fire alleged by plaintiff to have destroyed the property described in Paragraph I of the First Cause of Action of plaintiff's Complaint, setting forth particularly the time of day when the fire occurred, the cause of the fire insofar as plaintiff has been able to determine such cause, the steps, if any, which were taken by the

plaintiff in fighting the fire, what steps, if any, plaintiff took in attempting to salvage the property, and if any property was salvaged, a full and complete description of such property.

Dated at Anchorage, Alaska, this 26th day of May, 1949.

DAVIS & RENFREW,
Attorneys for Defendant,

By /s/ EDWARD V. DAVIS.

Receipt of Copy acknowledged.

[Endorsed]: Filed May 27, 1949.

[Title of District Court and Cause.]

REPLY

The plaintiff replies to defendant's affirmative defense and says:

I.

Admits that Exhibits 1 through 9 represent correspondence between plaintiff and defendant, but for lack of information, sufficient to form a belief, denies that said exhibits constitute the entire correspondence between plaintiff and defendant as alleged in Paragraph I.

II.

Denies all of the allegations contained in para-

graph II that are inconsistent with the allegations contained in plaintiff's causes of action.

McCUTCHEON & NESBETT,
Attorneys for Plaintiff,

By /s/ BUELL A. NESBETT.

Duly verified.

Receipt of copy acknowledged.

[Endorsed]: Filed June 11, 1949.

[Title of District Court and Cause.]

REQUEST FOR ADMISSIONS

Defendant Edward D. Coffey requests plaintiff, Antonio Polimeni, within ten (10) days after service of this request upon plaintiff's attorneys, to make the following admissions for the purpose of this action only, and subject to all pertinent objections to admissibility which may be interposed at the trial.

1. That Exhibits numbered one through nine, both numbers inclusive, attached to defendant's answer filed in the above-entitled matter, and copies of which are hereto attached represent all of the correspondence between plaintiff and defendant in connection with the proposal to secure insurance policy which is the subject of plaintiff's action.

2. That all negotiations had between plaintiff and defendant in connection with the proposed in-

insurance policy which is the subject of this action were had by correspondence between the parties, represented by Exhibits numbered one through nine set forth in the preceding statement. That plaintiff, Antonio Polimeni, at all times realized that Edward D. Coffey is what is known as an insurance broker, and that such person did not write insurance policies.

3. That plaintiff knew that no insurance policy was in effect covering his property at Naknek, Alaska, at the time of the fire which destroyed such property.

4. That no report of plaintiff's loss was made to the defendant Edward D. Coffey prior to the letter dated August 2, 1948, addressed to Edward D. Coffey at Anchorage, Alaska, and signed by Hal M. Marchbanks, United States Commissioner.

5. That plaintiff has not at any time furnished or attempted to furnish to defendant any proofs of loss or any statement concerning the alleged loss which might go to show that the fire which occasioned plaintiff's loss was within the terms of any insurance policy, had one been issued.

Dated at Anchorage, Alaska, this 22nd day of March, 1950.

DAVIS & RENFREW,

Box 477, Anchorage, Alaska, Attorneys for the Defendant.

By /s/ EDWARD V. DAVIS.

Receipt of Copy acknowledged.

[Endorsed]: Filed March 22, 1950.

[Title of District Court and Cause.]

RESPONSE TO REQUEST FOR ADMISSION

Plaintiff responds to defendant's request for admissions and says:

I.

Denies the allegations contained in paragraph I of defendant's request.

II.

Denies the allegations contained in paragraph II of defendant's request.

III.

Denies the allegations of paragraph III of defendant's request.

IV.

Plaintiff is not certain whether a report of his loss was made to the defendant prior to the letter of August 2, 1948, and therefore denies the allegations contained in paragraph IV of defendant's request.

V.

Denies the allegations contained in paragraph V of the defendant's request.

Dated at Anchorage, Alaska, this 28th day of March, 1950.

McCUTCHEON & NESBETT,
Attorneys for Plaintiff,

By /s/ BUELL A. NESBETT.

Duly verified.

Receipt of Copy acknowledged.

[Endorsed]: Filed, March 29, 1950.

[Title of District Court and Cause.]

The following is a true bill of particulars of those matters upon which you made demand for a Bill of Particulars.

McCUTCHEON & NESBETT,
Attorneys for Plaintiff.

By /s/ BUELL A. NESBETT.

BILL OF PARTICULARS

1. Plaintiff is unable to describe the said buildings with more particularity than is done in paragraphs 1, 2 and 3 of Exhibit “A” of plaintiff’s complaint, also Exhibit 3 of defendant’s answer.

2. The following is a list of furnishings contained in the buildings and an approximate inventory of supplies and merchandise located in the buildings:

Main Building

6 Tables approx. 22 x 34" @ 12.00	\$ 72.00
1 Dining table 4' x 8'	45.00
1 China closet	120.00
2 Dressers with mirrors @ 80.00	160.00
12 Chairs @ 5.00	60.00
1 Double bed, spring and mattress	80.00
4 ¾ size beds, springs and mattresses	400.00
1 Cot with spring and mattress	50.00
1 Lot of blankets, sheets, pillows and cases	50.00
1 Cook stove oil burner type	400.00
1 Hot water tank 80 gals. galv. iron	39.00
1 Automatic electric water pump and piping to well.....	226.00
1 Light plant Wisconsin motor D.C. generator	350.00
1 Lot pots and pans aluminum	150.00
1 Lot crockery dishes	300.00
1 Lot beer and wine glasses for the bar	80.00
Personal clothing and gear	500.00
Cash and currency buried in basement	2,000.00
Sub total	<u>\$5,082.00</u>

1 Lot of canned food as listed	\$3,047.24
6 Cases bottled beer @ 7.00	42.00
3 Cases sherry wine	75.00
2 Cases claret wine	50.00
3 Cases port wine	72.00

Totals\$8,368.24

Provisions List

Item	Amount	Cost	Total
Potatoes	10 sacks	\$11.00	\$110.00
Milk	25 cases	6.96	174.00
Peas	12 doz.	2.64	31.68
Corn	16 doz.	2.76	44.16
Carrots	12 doz.	3.00	36.00
Spinach	6 doz.	3.24	19.44
Sauerkraut	6 doz.	2.88	17.28
Peaches	12 doz.	4.80	57.60
Apricots	8 doz.	4.80	38.40
Pears	14 doz.	6.48	90.72
Cherries	6 doz.	5.04	30.24
Figs	4 doz.	5.40	21.60
Pineapple	8 doz.	5.04	40.32
Blackberries	2 doz.	4.68	9.36
Boysenberries	1 doz.	4.20	4.20
Raspberries	1 doz.	5.52	5.52
Spam	4 doz.	6.60	26.40
Beef and Gravy	6 doz.	5.52	38.12
Cod Fish	10 doz.	2.16	21.60
Oysters	4 doz.	6.60	26.40
Clams	2 doz.	5.88	11.76
Ham, canned 59# cans.....	8 cases	1.10 lb.	519.20
Corned Beef	24 doz.	4.92	118.08
Sardines	4 doz.	1.68	6.72
Wieners	12 doz.	7.20	86.40
Bacon, canned 24# cans.....	2 cases	.84 lb.	40.32
Bacon, slab	112 lbs.	.75	84.00
Flour, white	800 lbs.	9.50/100	76.00
Eggs	120 doz.	.80	96.00
Butter	150 lbs.	.90	135.00
Tomatoes	12 doz.	3.72	44.64
Onions	2 sacks	14.50	29.00
Macaroni	200 lbs.	.20	40.00
Spaghetti	400 lbs.	.20	80.00
Rice	1 sack	19.00	19.00
Beans	16 doz.	3.60	57.60
Beans, dry	1 sack	16.00	16.00
Beans, white	1 sack	16.00	16.00
Peas, split	75 lbs.	.14	10.50
Beans, lima	50 lbs.	.18	9.00

Item	Amount	Cost	Total
Prunes, dry	50 lbs.	.28	16.80
Apples, dried	50 lbs.	6.50/25#	13.00
Peaches, dried	50 lbs.	.30	15.00
Apricots, dry	40 lbs.	.48	15.20
Raisins, dry	25 lbs.	.24	6.00
Pears	50 lbs.	.40	20.00
Sugar	4 sacks	11.50	46.00
Salt, table	2 cases	3.12	6.24
Sugar, cube	48 lbs.	.17	8.16
Apple Jelly	2 doz.	3.24	6.48
Syrup	2 cases	5.40	10.80
Preserves, asst.	8 doz.	4.20	33.60
Catsup	4 doz.	2.88	11.52
A-1 Sauce	1 case	4.40	4.40
Mustard	3 cases	1.50	1.50
Salt Beef	400 lbs.	.73	292.00
Pigs Feet	200 lbs.	.47	94.00
Coffee	144 lbs.	.62	89.28
Tea	12 lbs.	1.40	16.80
Lard	18 lbs.	.40	7.20
Total.....			\$3,047.24

3. The fire occurred at approximately 1:00 a.m., July 20, 1948, cause being unknown. The building was unoccupied at time of fire insofar as plaintiff is aware; plaintiff was absent from Naknek and engaged in fishing at the time. Plaintiff is informed that no steps were taken to extinguish the fire for the reason that after discovery the heat was too intense to permit a close approach. Nothing was salvaged from the fire.

McCUTCHEON & NESBETT,
Attorneys for Plaintiff.

By /s/ BUELL A. NESBETT.

Duly verified.

Receipt of copy acknowledged.

[Endorsed]: Filed April 5, 1950.

[Title of District Court and Cause.]

MINUTES OF APRIL 17, 1950

Trial by Jury

Now on this 17th day of April, 1950, came the plaintiff and with Buell A. Nesbett and Stanley J. McCutcheon, of counsel and came also defendant with William W. Renfrew, of his counsel and both sides announcing themselves as ready for trial in Cause No. A-5366, entitled Antonio Polimeni, plaintiff versus Edward D. Coffey, defendant, the following proceedings were had, to wit:

The Deputy Clerk, under the direction of the Court, proceeded to draw from the Trial Jury Box, one at a time, the names of the members of the regular panel of Petit Jurors and respective counsel examined and exercised their challenges against said Jurors, so drawn.

At 11:05 o'clock a.m. Court duly admonished Jurors in Box and continued cause until 11:10 o'clock a.m.

Now came the Jurors in Box, who on being called, each answered to his or her name, came the respective parties, came also the respective counsel as heretofore and the trial of cause No. A-5366, entitled Antonio Polimeni, Plaintiff, versus Edward D. Coffey, defendant, was resumed.

Whereupon the Deputy Clerk, under the direction of the Court, continued to draw from the Trial Jury Box, one at a time, the names of the members of the

regular panel of Petit Jurors and respective counsel examined and exercised their challenges against said Jurors, so drawn, until both sides were satisfied and the Jury complete, consisting of the following named persons, to wit:

1. Ralph G. Carlson
2. Alice T. Stingle
3. Lorena H. Trudeau
4. Mrs. G. A. Benedict
5. Mary McDanell
6. Tom Kovac
7. Mrs. Lorene Gray
8. Andrew Longmire
9. Jean Wright
10. Ester Lounsbury
11. Fred S. Wilmans
12. Bertha Meier

which said Jury was duly sworn by the Deputy Clerk to well and truly try the matters at issue in the above-entitled cause and a true verdict render in accordance with the evidence and the instructions given by the Court.

At this time the Court excused the members of the regular panel of Petit Jurors, not engaged in the trial of this cause, to report at 10:00 o'clock a.m. of Wednesday, April 19, 1950.

At 11:40 o'clock a.m. Court duly admonished trial Jury and continued cause until 2:00 o'clock p.m.

Now came the Trial Jury, who on being called,

answered to his or her name, came the respective parties, came also the respective counsel as heretofore and the trial of cause No. A-5366, entitled Antonio Polimeni, plaintiff' versus Edward D. Coffey, defendant, was resumed.

Opening statement to the Jury was had by Buell A. Nesbett, for and in behalf of the plaintiff.

At this time Buell A. Nesbett, counsel for plaintiff, moves Court for leave to amend complaint by interlineation as follows:

In paragraph 7, 1st cause action; and in paragraph 5, 2nd cause of action by substituting date 7-20-48 for 7-9-48; Motion Granted.

Opening statement to the Jury was waived by William W. Renfrew, for and in behalf of the defendant.

William De Ville Smith, being first duly sworn, testified for and in behalf of the plaintiff.

At 3:30 o'clock p.m. Court duly admonished Trial Jury and continued cause until 3:40 o'clock p.m.

Now came the Trial Jury, who on being called, answered to his or her name, came the respective parties, came also the respective counsel as heretofore and the trial of cause No. A-5366, entitled Antonio Polimeni, plaintiff, versus Edward D. Coffey, defendant, was resumed.

Kenneth F. Shipley, being first duly sworn, testified for and in behalf of the plaintiff.

Albert Henry Ruhl, being first duly sworn, testified for and in behalf of the plaintiff.

Edward D. Coffey, being first duly sworn, testified for and in behalf of the plaintiff.

At 5:00 o'clock p.m. Court duly admonished Trial Jury and continued cause until 10:00 o'clock a.m. of Tuesday, April 18, 1950.

Entered Journal Apr. 17, 1950.

[Title of District Court and Cause.]

SUBPOENA

The President of the United States of America,
Greeting:

To Joseph Sheahan.

You Are Hereby Required, That all and singular business and excuses being set aside, you appear and attend before the District Court, Territory of Alaska, Third Division, to be held in the Court Room of said court at Anchorage, in the Territory of Alaska, on the 18th day of April, A.D. 1950, at 10 o'clock a.m., then and there to testify in the above-entitled cause, now pending in said Court, on the part of the Plaintiff, and you are not to depart the Court without leave of the Court.

And for failure to attend, as above required, you will be deemed guilty of contempt of Court, and liable to pay the party aggrieved all loss and damage sustained thereby.

Witness, the Honorable Anthony J. Dimond,
Judge of the said District Court, Territory of

Alaska, Third Division, and the seal of the said Court affixed this 17th day of April, in the year of our Lord one thousand nine hundred and fifty and of the Independence of the United States the one hundred and seventy-fourth.

M. E. S. BRUNELLE,
Clerk of the District Court, Territory of Alaska,
Third Division.

[Seal] By /s/ LOUISE STRAHUEN,
Deputy Clerk.

Marshal's return attached.

[Title of District Court and Cause.]

MINUTES OF APRIL 18, 1950

Trial by Jury Continued

Now came the Trial Jury, who on being called, each answered to his or her name, came the repective parties, came also the respective counsel as heretofore and the trial of cause No. A-5366, entitled Antonio Polimeni, Plaintiff, versus Edward D. Coffey, Defendant, was resumed.

Edward D. Coffey, heretofore duly sworn, resumed the witness stand for further testimony for and in behalf of the plaintiff.

Joseph Sheahan, being first duly sworn, testified for and in behalf of the plaintiff.

Letter, dated 3/30/48, to Edward D. Coffey by

Antonio Polimeni, was duly offered, marked and admitted as plaintiff's exhibit No. 1.

Copy of letter, dated 4/9/48, to Mr. Antonio Polimeni by Edward D. Coffey, was duly offered, marked and admitted as plaintiff's exhibit No. 2.

Letter, dated 4/17/48 to Edward D. Coffey by Antonio Polimeni was duly offered, marked and admitted as plaintiff's exhibit No. 3.

Letter, dated 6/1/48 to Ed. Coffey, by Antonio Polimeni, was duly offered, marked and admitted as plaintiff's exhibit No. 4.

Copy of letter, dated 6/4/48 to Mr. Antonio Polimeni by Edward D. Coffey, was duly offered, marked and admitted as plaintiff's exhibit No. 5.

Letter, dated 7/23/48 to Mr. Antonio Polimeni by Edward D. Coffey, was duly offered, marked and admitted as plaintiff's exhibit No. 6.

Letter, dated 8/2/48 to Mr. Edward D. Coffey by Hal M. Marchbanks was duly offered, marked and admitted as plaintiff's exhibit No. 7.

Copy of telegram, dated 8/5/48, to Hal M. Marchbanks by Edward D. Coffey was duly offered, marked and admitted as plaintiff's exhibit No. 8.

Copy of letter, dated 8/5/48 to Mr. Antonio Polimeni by Edward D. Coffey, was duly offered, marked and admitted as plaintiff's exhibit No. 9.

At 11:15 o'clock a.m. Court duly admonished the Trial Jury and continued cause to 11:20 o'clock a.m.

Now came the Trial Jury, who on being called, each answered to his or her name, came the respec-

tive parties, came also the respective counsel as heretofore and the trial of cause No. A-5366, entitled Antonio Polimeni, Plaintiff, versus Edward D. Coffey, Defendant, was resumed.

Joseph Sheahan, heretofore duly sworn, resumed the witness stand for further testimony for and in behalf of the plaintiff.

At 11:50 o'clock a.m. Court duly admonished the Trial Jury and continued cause to 2:00 o'clock p.m.

Now came the Trial Jury, who on being called, each answered to his or her name, came the respective parties, came also the respective counsel as heretofore and the trial of cause No. A-5366, entitled Antonio Polimeni, Plaintiff, versus Edward D. Coffey, Defendant, was resumed.

Joseph Sheahan, heretofore duly sworn, resumed the witness stand for further cross-examination for and in behalf of the defendant.

At 3:00 o'clock p.m. Court duly admonished the Trial Jury and continued cause to 3:10 o'clock p.m.

Now came the Trial Jury, who on being called, each answered to his or her name, came the respective parties, came also the respective counsel as heretofore and the trial of cause No. A-5366, entitled Antonio Polimeni, Plaintiff, versus Edward D. Coffey, Defendant, was resumed.

At this time Buell A. Nesbett, for and in behalf of the plaintiff, moves the Court for leave to amend complaint by interlineation to conform with the proof, in Paragraph 7, line 2, first cause of action,

by adding words "except the two auxiliary buildings"; same amendment in paragraph 5, second cause of action; motion allowed.

Antonio Polimeni, being first duly sworn, testified for and in his own behalf.

The plaintiff rests.

At this time William W. Renfrew, of counsel for defendant, moves the Court that jury be excused pending argument on point of law; jury duly admonished and excused to report at 10:00 o'clock a.m. of Wednesday, April 19, 1950.

Reporting waived.

At this time William W. Renfrew, of counsel for defendant, moves the court for judgment in behalf of the defendant.

Argument to the Court was had by William W. Renfrew, for and in behalf of the defendant.

At 4:55 o'clock p.m. Court continued cause to 10:00 o'clock a.m. of Wednesday, April 19, 1950.

Entered Apr. 18, 1950.

[Title of District Court and Cause.]

MINUTES OF APRIL 19, 1950

Trial by Jury Continued

Now came the Trial Jury, who on being called, each answered to his or her name, came the respective parties, came also the respective counsel as heretofore and the trial of cause No. A-5366, entitled

Antonio Polimeni, Plaintiff, versus Edward D. Coffey, Defendant, was resumed.

At this time trial jury excused to 2:00 o'clock p.m. this date, pending arguments on point of law.

Argument to the Court was had by Buell A. Nesbett for and in behalf of the plaintiff.

At 11:15 o'clock a.m. Court continued cause to 2:00 o'clock p.m.

Now came the Trial Jury, who on being called, each answered to his or her name, came the respective parties, came also the respective counsel as heretofore and the trial of cause No. A-5366, entitled Antonio Polimeni, Plaintiff, versus Edward D. Coffey, Defendant, was resumed.

At this time the Trial Jury was excused pending arguments on point of law.

Argument to the Court was resumed by Buell A. Nesbett, for and in behalf of the plaintiff. Court rules no contract and grants plaintiff to 10:00 o'clock a.m. of Thursday, April 20, 1950, to amend complaint if so desired.

At 2:35 o'clock p.m. Court duly admonished the Trial Jury and continued cause to 10:00 o'clock a.m. of Thursday, April 20, 1950.

Entered Apr. 19, 1950.

MINUTES OF APRIL 20, 1950

Trial by Jury Continued

Now came the Trial Jury, who on being called, each answered to his or her name, came the respective parties, came also the respective counsel as heretofore and the trial of cause No. A-5366, entitled Antoni Polimeni, Plaintiff, versus Edward D. Coffey, Defendant, was resumed.

At this time William Renfrew, in behalf of the defendant, renewed motion for dismissal.

Trial Jury was excused pending argument on points of law.

Argument to the Court was had by Edward V. Davis, for and in behalf of the Defendant.

Argument to the Court was by Buell A. Nesbett, for and in behalf of the plaintiff.

Argument to the Court was by Edward V. Davis, for and in behalf of the Defendant.

Argument to the Court was had by William Renfrew, for and in behalf of the Defendant.

Argument to the Court was had by Buell A. Nesbett, for and in behalf of the plaintiff.

Whereupon the Court having heard the arguments of the respective counsel and being fully and duly advised in the premises, denied motion.

At 11:00 o'clock a. m. Court duly admonished Trial Jury and continued cause until 11:05 o'clock a.m.

Now came the Trial Jury, who on being called,

each answered to his or her name, came the respective parties, came also the respective counsel as heretofore and the trial of cause No. A-5366, entitled Antoni Polimeni, Plaintiff, versus Edward D. Coffey, Defendants, was resumed.

Grace McConnell, being first duly sworn, testified for and in behalf of the defendant.

A letter, 1-23-48, to Edward D. Coffey, Agency by Cravens, Dargan and Co. was duly offered marked and admitted as Defendants exhibit "A."

At 11:50 o'clock a.m. Court duly admonished Trial Jury and continued cause until 2:00 o'clock p. m.

Now came the Trial Jury, who on being called, each answered to his or her name, came the respective parties, came also the respective counsel as heretofore and the trial of cause No. A-5366, entitled Antonio Polimeni, Plaintiff, versus Edward D. Coffey, Defendants, was resumed.

At this time Buell E. Nesbett, in behalf of the plaintiff, moves Court that jury be excused pending arguments on points of law; Motion Granted.

Argument to the Court was had by Buell E. Nesbett, for and in behalf of the plaintiff.

Jury recalled.

Grace McConnell, heretofore duly sworn, resumed witness stand for further testimony for and in behalf of the defendant.

Form 78, standard Forms Bureau form, was duly offered, marked and admitted as Defendants exhibit "B."

At 3:05 o'clock p.m. Court duly admonished Trial Jury and continued cause until 3:10 o'clock p.m.

Now came the Trial Jury, who on being called, each answered to his or her name, came the respective parties, came also the respective counsel as heretofore and the trial of cause No. A-5366, entitled Antonio Polimeni, Plaintiff, versus Edward D. Coffey, Defendant, was resumed.

Grace McConnell being heretofore duly sworn, resumed witness stand for further cross-examination for and in behalf of the plaintiff.

Antonio Polimeni, heretofore duly sworn, resumed witness stand for further cross-examination for and in behalf of the defendant.

Daniel H. Cuddy, being first duly sworn, testified for and in behalf of the defendant.

Defendant Rests.

At 3:35 o'clock p.m. Court duly admonished Trial Jury and continued cause until 3:40 o'clock p.m.

Now came the Trial Jury, who on being called, each answered to his or her name, came the respective parties, came also the respective counsel as heretofore and the trial of cause No. A-5466, entitled Antonio Polimeni, Plaintiff, versus Edward D. Coffey, Defendant, was resumed.

William de Ville Smith, heretofore duly sworn resumed witness stand for further testimony for and in behalf of the plaintiff.

Plaintiff Rests.

Defendant Rests.

William Renfrew, in behalf of the defendant, renews motion for dismissal; Motion Denied.

At 4:00 o'clock p.m. Court duly admonished Trial Jury and continued cause until 10:00 o'clock of Friday April 21, 1950.

[Title of District Court and Cause.]

MINUTES OF APRIL 21, 1950

Trial by Jury Continued

Now came the Trial Jury, who on being called, each answered to his or her name, came the respective parties, came also the respective counsel as heretofore and the trial of cause No. A-5366, entitled Antonio Polimeni, Plaintiff, versus Edward D. Coffey, Defendant, was resumed.

Opening argument to the jury was had by Buell A. Nesbett, for and in behalf of the plaintiff.

Argument to the Jury was had by William W. Renfrew, for and in behalf of the defendant.

At 11:25 o'clock a.m. Court duly admonished the Trial Jury and continued cause to 11:30 o'clock a.m.

Now came the Trial Jury, who on being called, each answered to his or her name, came the respective parties, came also the respective counsel as heretofore and the trial of cause No. A-5366, entitled Antonio Polimeni, Plaintiff, versus Edward D. Coffey, Defendant, was resumed.

Closing argument to the Jury was had by Buell A. Nesbett, for and in behalf of the defendant.

At 11:45 o'clock a.m. Court duly admonished the Trial Jury and continued cause to 2:00 o'clock p.m.

Now came the Trial Jury, who on being called, each answered to his or her name, came the respective parties, came also the respective counsel as heretofore and the trial of cause No. A-5366, entitled Antonio Polimeni, Plaintiff, versus Edward D. Coffey, Defendant, was resumed.

Argument to the Jury was resumed by Buell A. Nesbett, for and in behalf of the plaintiff.

At this time by leave of the Court, William W. Renfrew, of counsel for defendant, amends the answer filed by the defendant by substituting page 2 of the original answer with the amendment on contributory negligence, also numbered page 2.

At this time the Court read his instructions to the Jury and Don Carlquist and John Mack were duly sworn by the Deputy Clerk of the Court as bailiffs in charge of said Jurors and at 3:20 o'clock p.m. Jury retired in charge of their sworn bailiffs to deliberate upon their verdict.

Entered April 21, 1950.

[Title of District Court and Cause.]

REQUESTED INSTRUCTIONS ON
BEHALF OF DEFENDANT

1.

You are instructed that the burden is upon the plaintiff in this case to establish his right to recovery against the defendant by a fair preponderance of the evidence in all the elements material to his right to recover as hereinafter set forth.

The elements which plaintiff must prove, as above set forth, are as follows:

(1) That defendant Edward D. Coffey owed a duty to plaintiff to secure insurance for plaintiff;

(2) That defendant Edward D. Coffey, through negligence or want of due care, failed to procure insurance for the plaintiff or to notify the plaintiff that he did not intend to attempt to procure such insurance;

(3) That except for the failure of defendant Coffey to act on plaintiff's letter, insurance would have been issued covering the property which Mr. Polimeni, the plaintiff, desired insured;

(4) That Mr. Polimeni had an insurable interest in the property;

(5) That the fire which burned the property concerning which Mr. Polimeni has made claim, would have come within the provisions of the policy of insurance, if such policy had been issued;

(6) That the property Mr. Polimeni claims to have been lost was of a kind which would have been covered by insurance had insurance been procured;

(7) That plaintiff suffered damage by reason of the loss and that such damage would have been covered by insurance had a policy been secured; and

(8) The amount of the damage resulting from the fire with particularity and without speculation;

Unless each and all of these elements have been proved to your satisfaction by a fair preponderance of the evidence, your verdict must be for the defendant.

2.

You are instructed that the burden of proof is upon the plaintiff in this case not only to show the amount of any damage or loss for which he sues, and that such damage or loss was sustained as a result of the alleged fire, but also to show that such damage or loss would have been covered by an insurance policy had such policy been procured for the plaintiff by the defendant, according to plaintiff's letter.

3.

You are instructed that unless plaintiff has proved to your satisfaction, by a fair preponderance of the evidence, that he was the sole and undisputed owner of the property concerned in this action, then plaintiff is not entitled to recover anything by reason of the loss of such property, and in that event your verdict should be for the defendant.

4.

You are instructed that in this case, as in all other cases, plaintiff was required to use due care for the protection of his own property, irrespective of any want of care or negligence on behalf of the defendant. Accordingly, if you should find from the evidence that the plaintiff, Mr. Polimeni, could have, in the exercise of due care on his part, secured insurance either through Mr. Coffey or from some other source, after he knew or should have known by the exercise of due care that Mr. Coffey had not procured an insurance policy on his behalf, then plaintiff is not entitled to recover against the defendant, even though you should find that the defendant owed a duty to the plaintiff and did not use due care in attempting to perform that duty.

5.

You are instructed that if you believe that Mr. Polimeni, in his letter, made a misstatement of fact as to the location of the electric light plant, and if you further find that the electric light plant in its actual location would tend to increase the risk involved from the standpoint of insurance written on the property, then you are instructed that regardless of any duty of the defendant to the plaintiff and regardless of any negligence or lack of care by the defendant, your verdict must be for the defendant.

6.

You are instructed that you should not consider the value of any money or currency buried in the

basement, or hidden elsewhere on the premises, in determining any damages that plaintiff may have suffered, for the reason that it stands undisputed that such money would not have been insured even though an insurance policy had been procured.

[Endorsed]: Filed April 21, 1950.

PLAINTIFF'S REQUESTED INSTRUCTIONS

No. 1

Where an insurance broker or agent undertakes to procure insurance for another, he is bound to exercise reasonable diligence to obtain same and to give timely notice to his principal in the event he is unable to procure the insurance requested by his principal, and any loss resulting to his principal by reason of the inattention, neglect or incapacity of the broker or agent makes the broker or agent personally liable to his principal.

Rezac vs. Zima—Kansas

153 Pac 500

Harrod vs. Latham—Kansas

95 Pac 11

Manny vs. Dunlap—C.C., Iowa

Fed. Cases 9,047

Wallace vs. Hartford Fire Ins. Co.—

174 Pac 1009

No. 2

In this case the plaintiff contends that the de-

defendant was negligent in losing or misplacing the plaintiff's letter dated April 17, 1948 (Plaintiff's Exhibit #3), until July 23, 1948, which admittedly was received by defendant on April 24, 1948, and that by reason of the said negligence defendant failed to accomplish insurance coverage of plaintiff's property before it was destroyed by fire on July 20, 1948.

If you believe that the defendant was negligent in failing to cover plaintiff's property by insurance before it was destroyed by fire, or in giving plaintiff timely notice of his, the defendant's, inability to effect such insurance coverage, you will bring in a verdict for the plaintiff.

If you believe the defendant was not etc., etc.

Manny vs. Dunlap—C.C., Iowa

Fed Cases 9,047

Morris vs. Summerl—C.C., Penn.

Fed. Cases 9,837

and other authorities cited.

No. 3

You are instructed that if you find the defendant guilty of negligence in failing to attempt to procure insurance for the plaintiff, the measure of damages is the amount of insurance that would have been procured had the defendant acted with reasonable diligence, in this case the sum of \$10,000.00, less the amount of the premium that would have been paid to the defendant, in this case the sum of \$300.00, less what you consider to be the reasonable value of

the two auxiliary buildings which were not destroyed by fire.

Receipt of copy acknowledged.

[Endorsed]: Filed April 21, 1950.

[Title of District Court and Cause.]

COURT'S INSTRUCTIONS TO THE JURY

No. 1

Ladies and Gentlemen of the Jury:

We have now reached the point in the trial of this case where it becomes the duty of the Court to instruct you as to the law that will govern you in your deliberations upon the facts of this case.

When you were accepted as jurors in this case you obligated yourselves by your oaths to well and truly try the matter in issue between the plaintiff and the defendant, and a true verdict render according to the law and the evidence as given to you on the trial. That oath means that you will not be swayed by passion, sympathy or prejudice, and that your verdict will be the result of a careful consideration of all the evidence and the instructions of the Court as to the law.

Neither the statements of counsel engaged in the trial of this case, nor the allegations of the pleadings, except so far as they constitute admissions, are to be considered by you as proof of the facts to which they relate. You should not regard or con-

sider the relative financial condition of the parties to the suit, nor the effect of your verdict upon the parties, or any of them, or attempt to arrive at a verdict based upon your individual or collective opinions as to the abstract principles of justice which should govern the case.

It is not for you to say what the law is or should be regardless of any idea you may have in that respect. It is the exclusive province of the Court to declare the law in these instructions, and it is your duty as jurors to follow them in your deliberations and in arriving at a verdict.

On the other hand it is the exclusive province of the jury to declare the facts in the case, and your decision in that respect, as embodied in your verdict, when arrived at in a regular and legal manner, is final and conclusive upon the Court. Therefore probably the greater ultimate responsibility in the trial of the case rests upon you, because you are the triers of the facts.

No. 2

By this action plaintiff seeks to recover damages in the sum of \$10,000 from defendant for alleged negligent delay in procuring insurance against fire on property consisting of 3 buildings at Naknek and contents which plaintiff alleges belonged to him and were of the value of \$10,000.

The complaint alleges that at all times material to this action the defendant was engaged as agent in the insurance business; that on March 30, 1948, plaintiff inquired of defendant regarding insurance on the property aforesaid; that the defendant re-

plied, requesting certain information and that on April 17th, plaintiff supplied the requested information, but that the defendant negligently mislaid said letter and failed to procure the insurance applied for and that on July 20th the property with the exception of two auxiliary buildings was totally destroyed by fire, in consequence of which plaintiff alleges he was damaged in the sum of \$10,000, less the value of the buildings referred to.

By his answer, the defendant denies that there was any negligence on his part and denies plaintiff's ownership of the property, thus placing upon the plaintiff the burden of proving the foregoing allegations of the complaint by a preponderance of the evidence. Unless the plaintiff sustains this burden, he cannot recover. The defendant also alleges that the plaintiff was guilty of **contributory negligence** by failing to act on plaintiff's exhibit No. 5. The burden of proving contributory negligence on the part of the plaintiff by a preponderance of the evidence is on the defendant.

No. 3

The questions for your determination are:

(1) Whether the defendant was negligent in not acting on plaintiff's application within a reasonable time.

(2) Whether, but for such negligence, if any, plaintiff would have received the insurance applied for.

(3) The value and ownership of the property destroyed, except money, for which insurance was applied for in the letter of April 17, 1948, plaintiff's exhibit No. 3.

(4) Whether the defendant's negligence, if any, was the proximate cause of the alleged loss; and, if so, whether the plaintiff was guilty of contributory negligence.

No. 4

You are instructed that if you find that upon the receipt of plaintiff's application for insurance, as a result of previous correspondence and relations between the parties, there arose a duty on the part of the defendant to act promptly on the application, with a view to procuring insurance without unreasonable delay, or in case of rejection or insufficiency of the application, to promptly notify the plaintiff thereof, then for a negligent failure to do so, defendant would be liable to plaintiff for any loss proximately caused thereby, unless you find that the plaintiff was guilty of contributory negligence.

No. 5

Negligence, as used in the law applicable to this case, is the failure to exercise due care—that is, such care as an ordinarily prudent person would exercise under like circumstances. It is the doing of something which a person of ordinary prudence and that a person of ordinary prudence and care would care would not have done under like or similar circumstances, or it may be the failure to do something

not have omitted to do under similar circumstances. What constitutes negligence in any particular case depends upon the facts and circumstances.

It is for you to say whether the defendant was negligent in the respect alleged, or whether the delay, if any, was unreasonable.

No. 6

By proximate cause is meant the probable and direct cause. It is the cause which directly produces the damage and without which the damage would not have occurred. Unless, therefore, the negligence, if any, of the defendant was the proximate cause of the damage, the defendant would not be liable under the theory of negligence.

An act of negligence is the proximate cause where the damage is the ordinary, natural and probable result of the negligence and where the damage would not have occurred except for such negligence.

No. 7

If, therefore, you find from a preponderance of the evidence that the plaintiff in response to defendant's letter of April 9, 1948, applied for insurance in the amount of \$10,000 on the property referred to, but that the defendant neglected to act upon such application within a reasonable time and that in the meantime plaintiff's property was destroyed by fire, and further find that, but for such negligence, if any, the plaintiff would have received the insurance applied for and would not have sustained the loss alleged, you should find for the plaintiff in such

sum as you find as he has been damaged, not exceeding the amount sued for after deducting the value of the two buildings not destroyed, and the amount of the premium.

On the other hand, if you do not so find or if you find that the plaintiff was guilty of contributory negligence, or believe that the evidence is evenly balanced, you should find for the defendant.

No. 8

Contributory negligence is negligence on the part of the one suing for damages which, cooperating in some degree with the negligence of another, contributes to the injury or loss for which damages are sought. One who is guilty of contributory negligence may not recover from another for the loss sustained. Therefore, if you find from a preponderance of the evidence that the defendant was guilty of negligence in the respect alleged but further find that the plaintiff was likewise negligent in the respect charged in the answer and that such neglect combined and concurred with the negligence of the defendant in proximately causing the loss, you should find for the defendant.

No. 9

The measure of damages is the amount the plaintiff would have been entitled to recover had the policy applied for been issued—in other words, the replacement value of the building and fixtures, and the reasonable market value of the personal property, not exceeding in the aggregate the sum of \$10,000, less the value of the two buildings not destroyed, and the cost of the premium.

No. 10

You are instructed that you should not consider the value of any money or currency buried in the basement, or hidden elsewhere on the premises, in determining any damages that plaintiff may have suffered, for the reason that it stands undisputed that such money would not have been insured even though an insurance policy had been procured.

No. 11

By reasonable market value is meant that sum of money that an owner desirous of selling but not compelled to do so can secure in cash within a reasonable time in the open market from a person who is desirous of buying but under no compulsion to do so.

No. 12

In a civil case, such as this is, the burden of proof rests upon the party holding the affirmative with respect to any issue, and under that rule he is required to prove such issue by a preponderance of the evidence. By a preponderance of the evidence is meant the greater weight of the credible evidence, that evidence which in your judgment is the better evidence and which has the greater weight and value and the greater convincing power. This does not necessarily depend on the number of witnesses testifying with respect to any question of fact, but it means simply the greater weight or the greater value and convincing power and which is the most worthy of belief; and so, after having heard and considered all the evidence in the case on any issue,

you are unable to say upon which side of that issue the evidence weighs the more heavily, or if the evidence is evenly balanced on any particular issue in the case, then the party upon whom the burden rests to establish such issue must be deemed to have failed to prove it.

No. 13

The law forbids quotient verdicts. A quotient verdict is arrived at by having each juror write the amount of damages or compensation to which he believes the plaintiff is entitled, adding the twelve amounts so set down, and then dividing the total by twelve, the resulting figure being given as the verdict of the jury. Such verdicts are highly improper and under no circumstances should you resort to that method of adjusting differences of opinion among yourselves.

No. 14

Subject to the law as contained in these instructions, you are also the exclusive judges of the credibility of the witnesses and of the effect and value of the evidence, except such evidence as is declared by the Court to be conclusive.

You are, however, instructed that your power of judging the effect of evidence is not arbitrary but is to be exercised by you with legal discretion and in subordination to the rules of evidence; that the oral admissions of a party should be viewed with caution; that evidence is to be estimated not only by its own intrinsic weight but also according to the evidence which it is in the power of one side to pro-

duce and of the other to contradict and, therefore, if weaker and less satisfactory evidence is offered when it appears that stronger and more satisfactory evidence was within the power of the party offering it, such evidence should be viewed with distrust.

Before reaching a verdict you will carefully consider and compare all the testimony. In determining the credibility of witnesses and the weight to be given their testimony, you should decide what testimony is to be believed in the same way as you would decide whether to believe something told you out of court. You size up the witness in court the same way as an informant out of court, observe his appearance and demeanor, note his intelligence, whether he is candid and fair, whether he has an interest in the outcome of the trial, what motive he may have for testifying as he did, the opportunity he had to observe or learn or remember the truth, the facts to which he testified, the probability or improbability of his testimony, his bias or prejudice against or inclination to favor either party, and the extent to which he is corroborated or contradicted and all the other facts and circumstances which shed light on the witness' credibility and the weight of his testimony. When a witness has a strong personal interest in the outcome of a case, the temptation to lie, or to color, distort or withhold the truth may likewise be strong. Notwithstanding that, however, you may find that he has told the truth. What has just been said concerning interest in the outcome of a case is likewise applicable to bias or prejudice

against or a disposition to favor, either party. In other words, you should bring to bear upon your consideration of the evidence or lack of evidence in this case your common knowledge and experience in life. Accordingly, you should draw from the evidence in this case all deductions which appear to you to flow logically from such evidence. Whatever verdict is warranted by the evidence under the instructions of the Court, you should return as you have sworn to do.

You are not bound to find in conformity with the declarations of any number of witnesses which do not produce conviction in your minds against a less number or against a presumption or other evidence satisfying your minds. The direct evidence of one witness whom you find to be entitled to full credit is sufficient for the proof of any fact in this case. A witness wilfully false in one part of his testimony may be distrusted in other parts. Whenever it is possible you will reconcile conflicting or inconsistent testimony, but where it is not possible to do so, you should give credence to that testimony which, under all the facts and circumstances of the case, appeals to you as the most worthy of belief.

You are also instructed that the opening statements and the arguments of counsel are not evidence, and they are not binding upon you. You may, however, be guided by them if you find that they are based on the admitted evidence and appeal to your reason and judgment, and are not in conflict with the law as set forth in these instructions.

No. 15

Under the law each party to a civil action—that is, the plaintiff and the defendant—is a competent witness in his own behalf or in behalf of the other party. In determining the credibility and the weight and value of the testimony, you should take into consideration the fact that they are interested and give their testimony in connection with all the other evidence in the case such weight as you believe it entitled to.

No. 16

The law requires that all twelve jurors must agree upon a verdict before one can be rendered.

While no juror should yield a sincere conviction, founded upon the law and the evidence of the case, merely to agree with other jurors, every juror, in considering the case with fellow jurors, should lay aside all undue pride or vanity of personal judgment, and should consider differences of opinion, if any arise, in a spirit of fairness and candor, with an honest desire to get at the truth, and with the view of arriving at a just verdict because the law contemplates that the verdict shall be the product of the collective judgment of the entire jury.

Accordingly, no juror should hesitate to change the opinion he has entertained, or expressed, if honestly convinced that such opinion is erroneous, even though in so doing he adopts the views and opinions of other jurors.

No. 17

You are to consider these instructions as a whole. It is impossible to cover the entire case with a single

instruction, and you should not single out one particular instruction and consider it by itself or separately from or to the exclusion of all the other instructions.

As you have been heretofore instructed, your duty is to determine the facts of the case from the evidence submitted, and to apply to these facts the law as given to you by the Court in these instructions. The Court does not, either in these instructions or otherwise, wish to indicate how you shall find the facts or what your verdict shall be, or to influence you in the exercise of your right and duty to determine for yourselves the effect of evidence you have heard or the credibility of witnesses, because the responsibility for the determination of the facts in this case rests upon you and upon you alone.

No. 18

Upon retiring to your jury room you will select one of your number foreman, who will speak for you and sign the verdict unanimously agreed upon.

You will take with you to the jury room the exhibits, the bill of particulars and these instructions, together with two forms of verdict, which are self-explanatory.

If you agree upon a verdict during business hours, that is, between 9 a.m. and 5 p.m., you may have your foreman date and sign it and then return it into open court in the presence of the entire jury, together with these instruction, the exhibits, the bill of particulars, and the unused form of verdict. If, however, you agree upon a verdict after business

hours, that is, after 5 p.m. one day and before 9 a.m. the following day, you should similarly have your foreman date and sign it and seal it in the envelope accompanying these instructions. The foreman will then keep it in his possession unopened and the jury may separate and go to their homes, but all of you must be in the jury box when the court next convenes at 10 a.m. when the verdict will be received from you in the usual way.

Given at Anchorage, Alaska, this 21st day of April, 1950.

/s/ GEORGE W. FOLTA,
District Judge.

[Endorsed]: Filed April 21, 1950.

[Title of District Court and Cause.]

VERDICT

Trial by Jury Continued

Now at 10:00 o'clock a.m. came the Jury, in charge of their sworn bailiffs, who, on being called, each answered to his or her name, came also the respective parties, with their respective counsel and said Jury did present by and through their Foreman, in open Court, their verdict in cause No. A-5366, entitled Antonio Polimeni, Plaintiff, vs. Edward D. Coffey, defendant, which is in words and figures as follows, to wit:

which verdict the Court ordered filed and discharged the Jury to report at 2:00 o'clock p.m. of this date.

In the District Court for the Territory of Alaska,
Division Number Three, at Anchorage

No. A-5366

ANTONIO POLIMENI,

Plaintiff,

vs.

EDWARD D. COFFEY,

Defendant.

EXHIBIT No. I

We, the jury, duly impanelled and sworn to try
the above-entitled cause, find for the plaintiff and
assess his damages in the sum of \$9200.00.

Dated at Anchorage, Alaska, this 21st day of
April, 1950.

/s/ FRED S. WILMANS,
Foreman.

Entered Apr. 24, 1950.

[Endorsed]: Filed April 24, 1950.

In the District Court for the Territory of Alaska,
 Division Number Three, at Anchorage
 No. A-5366

ANTONIO POLIMENI,

Plaintiff,

vs.

EDWARD D. COFFEY,

Defendant.

EXHIBIT No. II

We, the jury, duly impanelled and sworn to try
 the above-entitled cause, find for the defendant.

Dated at Anchorage, Alaska, this day of
 April, 1950.

.....

Foreman.

[Endorsed]: Filed April 24, 1950.

In the District Court for the Territory of Alaska,
Third Division

No. A-5366

ANTONIO POLIMENI,

Plaintiff,

vs.

EDWARD D. COFFEY,

Defendant.

JUDGMENT

The above-entitled action came on regularly for trial commencing on the 17th day of April, 1950, and concluding on the 21st day of April, 1950, before the above-entitled court at Anchorage, Alaska, the Honorable George W. Folta, sitting as Judge, the plaintiff being represented by McCutcheon and Nesbett, his attorneys, and the plaintiff, Antonio Polimeni, being present in person, and the defendant being present in court and represented by Renfrew and Davis, his attorneys, a jury of twelve persons was regularly impaneled and sworn to try the cause and testimony both oral and documentary having been introduced and submitted on behalf of the plaintiff and defendant, whereupon the court instructed the jury upon the law in the matter, and counsel for both sides having argued the matter to the jury, and the jury having retired to consider their verdict, the jury was directed to bring in a sealed verdict. Thereupon, and at ten o'clock a.m. on the 24th day of April, 1950, the jury returned

into court and returned their sealed verdict, which upon being unsealed in open court and in the presence of the jury was found to be a verdict in favor of the plaintiff reading as follows: Exhibit No. 1. "We, the jury, duly impaneled and sworn to try the above-entitled cause, find for the plaintiff and assess his damages in the sum of \$9,200.00. Dated at Anchorage, Alaska, this 21st day of April, 1950. Fred S. Wilmans, Foreman."

Wherefore by virtue of the law and by reason of the premises aforesaid, it is hereby

Ordered, Adjudged and Decreed, that judgment be and is hereby given in favor of the plaintiff, Antonio Polimeni, in the sum of \$9,200.00, plus interest in the sum of \$., and that the plaintiff shall have and recover of and from the defendant the plaintiff's costs and disbursements in this action incurred to be taxed by the Clerk of the Court in the manner provided by law, and an attorneys fee in the sum of \$750.

Dated at Anchorage, Alaska, this 27th day of April, 1950.

/s/ GEORGE W. FOLTA,
District Judge.

Entered April 27, 1950.

Receipt of Copy Acknowledged.

[Endorsed]: Filed April 27, 1950.

[Title of District Court and Cause.]

MOTION TO SET ASIDE VERDICT AND
JUDGMENT AND FOR JUDGMENT IN
FAVOR OF THE DEFENDANT

Comes now Edward D. Coffey, the above-named defendant, and moves that the verdict rendered by the jury in the above-entitled cause against the defendant in the amount of \$9,200.00, rendered on the 27th day of April, 1950, may be set aside, and that judgment entered in favor of the plaintiff and against the defendant following such verdict, may be vacated, and that judgment may be entered in favor of the defendant in accordance with the motion of such defendant for directed verdict made at the close of plaintiff's case and at the close of all of the evidence. In the alternative, defendant moves for a new trial, all as will more fully appear from the motion for new trial to be filed in this cause.

This motion is based upon the fact that as will more fully appear from all the records and files of this action, that the defendant, Edward D. Coffey, at the close of plaintiff's evidence, and again at the close of all of the evidence, moved for the direction of a verdict in his favor on the ground that the evidence was insufficient to justify judgment in favor of the plaintiff and against the defendant, and in particular, the fact that there is no evidence of any duty owned by the defendant Coffey to the plaintiff Polimeni, thus precluding any question of tort liability for negligence.

Dated at Anchorage, Alaska, this 1st day of May, 1950.

DAVIS & RENFREW,

By /s/ WILLIAM W. RENFREW,
Attorneys for the Defendant.

Receipt of Copy Acknowledged.

[Endorsed]: Filed May 1, 1950.

[Title of District Court and Cause.]

MOTION FOR NEW TRIAL

Comes now Edward D. Coffey, the above-named defendant, by and through his attorneys, and moves that the verdict rendered in the above-entitled cause on the 27th day of April, 1950, in favor of the plaintiff and against the defendant, in the amount of \$9,200.00, may be vacated, and that a new trial may be granted in such action for the following reasons:

1. That the verdict as rendered by the jury is not supported by sufficient evidence, but is contrary to the evidence.
2. That the verdict against the defendant as given is against the law.
3. That the verdict as rendered is for excessive damages, appearing to have been given under the influence of sympathy or prejudice or passion, and

is far in excess of any amount to which the plaintiff might be entitled under the evidence of the cause.

4. That certain errors of law occurred at the trial, which errors were excepted to by the defendant as follows:

A. The Court erred in refusing to direct a verdict in favor of the defendant at the close of plaintiff's evidence as requested by such defendant, to which ruling the defendant objected, and an exception was saved on behalf of such defendant at the time the ruling was made.

B. That the Court erred in refusing to grant defendant's motion for a directed verdict made at the close of all of the evidence, for the reason that there was no substantial evidence for the jury to consider from which the liability of the defendant Edward D. Coffey might be inferred, and in particular, that there was no evidence of a breach of a duty by the defendant Edward D. Coffey.

C. That the Court erred in submitting the matter to the jury at all, for the reason that the sole question for determination was a question of law.

D. That the Court erred in submitting the matter to the jury for the reason that there was no substantial evidence from which any liability of such defendant might be found.

E. The Court erred in instructing the jury in failing to give certain instructions requested by the defendant, and in instructing the jury as the Court instructed the jury, defendant having saved exceptions to such failure to give instructions and to the

instructions as given, all as will more fully appear from the exceptions taken by the defendant at the close of the trial, for the reason that the requested instructions were proper statements of the law in view of the evidence of the case, and that the instructions given, and to which defendant excepted, were not proper statements of the law in connection with such evidence, and were prejudicial to the defendant.

F. That the Court erred in receiving the verdict of the jury in the above-entitled cause for the reason that such verdict is contrary to the evidence, and not supported by any substantial evidence, and for the reason that the plaintiff has wholly failed in his proof to show any liability of the defendant to the plaintiff in any manner whatsoever.

G. That the Court erred in entering judgment following the verdict in the above-entitled matter for the reason that such verdict is not supported by any substantial evidence, and is contrary to the evidence, and the judgment against the defendant and in favor of the plaintiff is contrary to law.

Dated at Anchorage, Alaska, this 1st day of May, 1950.

DAVIS & RENFREW,

By /s/ WILLIAM W. RENFREW,

Attorneys for the Defendant.

Receipt of Copy Acknowledged.

[Endorsed]: Filed May 1, 1950.

[Title of District Court and Cause.]

MEMORANDUM OF COSTS
AND DISBURSEMENTS

Disbursements

Marshal's Fee, See Exhibit "A".....	\$ 11.50
Clerk's Fees	21.00
Witness Fees, See Exhibit "A".....	239.00
Attorneys	750.00
Transportation Witnesses, See Exhibit "A"	310.80
<hr/>	
Total	\$1,332.30

United States of America,
Territory of Alaska, Third Division—ss.

Buell A. Nesbett being duly sworn, deposes and says: That he is the Attorney for the Plaintiff in the above-entitled cause, and as such is better informed relative to the above costs and disbursements, than the said Plaintiff. That the items in the above memorandum contained are correct, to the best of this deponent's knowledge and belief, and that the said disbursements have been necessarily incurred in the said cause.

/s/ BUELL A. NESBETT,

Subscribed and sworn to before me, this 3rd day of May, A.D. 1950.

M. E. S. BRUNELLE,
Clerk of the District Court, Territory of Alaska,
Third Division.

[Seal] By /s/ CHARLES M. KNOTT,
Deputy.

Receipt of Copy Acknowledged.

[Endorsed]: Filed May 3, 1950.

EXHIBIT "A"

Marshal's fees—

Serving Complaint	\$ 3.00
Subpoena	5.50

Witness Fees

Plaintiff—home in Naknek

9 days @ \$9.00 a day	81.00
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Al Ruhl—home in Naknek

7 days @ \$9.00 a day	63.00
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Kenneth Shipley—home in Anchorage

7 days @ \$4.00	28.00
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Joseph Sheahan—1 day @ \$4.00	4.00
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William Smith—home in Dillingham

7 days @ \$9.00	63.00
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Witness fees total	\$239.00
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Transportation of Witnesses

Polimeni & Ruhl—Naknek to Anchorage
and return—644 miles @ 15c per mile .. 193.20

William Smith—Dillingham to Anchor-
age and return 117.60

Total\$310.80

[Endorsed]: Filed May 3, 1950.

MINUTE ORDER DENYING MOTION FOR
NEW TRIAL

Now at this time upon the Court's own motion,

It Is Ordered that motion for new trial in cause No. A-5366, entitled Antonio Polemini, Plaintiff versus Edward D. Coffey, Defendant be and it is hereby denied.

Entered May 5, 1950.

MINUTE ORDER DENYING MOTION TO SET
ASIDE VERDICT AND JUDGMENT AND
FOR JUDGMENT IN FAVOR OF DEFEND-
ANT

Now at this time on Court's own motion,

It Is Ordered that motion to set aside verdict and Judgment and for Judgment in favor of defendant in cause No. A-5366, entitled Antonio Polimeni,

Plaintiff, versus Edward D. Coffey, Defendant, be and is hereby denied.

Entered May 5, 1950.

[Title of District Court and Cause.]

NOTICE OF APPEAL

Notice is hereby given that Edward D. Coffey, the above-named defendant, hereby appeals to the Court of Appeals for the Ninth Circuit from that certain final judgment entered by the above-entitled Court in the above-entitled cause on the 27th day of April, 1950, by the terms of which judgment was granted in favor of the plaintiff, Antonio Polimeni, and against the defendant, Edward D. Coffey, in the sum of \$9,200.00, plus attorney's fees to the plaintiff in the amount of \$750.00, and together with costs and disbursements to be taxed by the Clerk of the Court, such judgment having been entered on the said 27th day of April, 1950.

DAVIS & RENFREW,

By /s/ EDWARD V. DAVIS,

Attorneys for the Defendant,
Edward D. Coffey.

Receipt of Copy Acknowledged.

[Endorsed]: Filed May 24, 1950.

MINUTE ORDER FIXING SUPERSEDEAS BOND

Now at this time upon motion of Edward V. Davis, of counsel for defendant, and with Buell A. Nesbett, of counsel for plaintiff not objecting,

It Is Ordered that supersedeas bond in cause No. A-5366, entitled Antonio Polimeni, Plaintiff, versus Edward D. Coffey, Defendant, be, and it is hereby, fixed at \$11,500.00.

Entered May 24, 1950.

[Title of District Court and Cause.]

ORDER

Stipulation having been entered by attorneys for the respective parties that supersedeas bond on appeal in the above-entitled matter might be set at the sum of Eleven Thousand Five Hundred Dollars (\$11,500.00), and the Court being fully advised in the premises, now, therefore,

It Is Hereby Ordered, Adjudged and Decreed that supersedeas bond on appeal in the above matter shall be set at the sum of Eleven Thousand Five Hundred Dollars (\$11,500.00), and the judgment will be stayed furnishing of a good and sufficient bond in that sum by the defendant-appellant.

Done in open Court at Anchorage, Third Judicial

Division, Territory of Alaska, this 24th day of May, 1950.

/s/ ANTHONY J. DIMOND,
District Judge.

Entered May 24, 1950.

Receipt of Copy Acknowledged.

[Endorsed]: Filed May 24, 1950.

[Title of District Court and Cause.]

DESIGNATION OF CONTENTS OF RECORD
ON APPEAL

To the Clerk of the above-entitled Court and to McCutcheon & Nesbett, attorneys for the Plaintiff, and To Whom It May Concern:

Please Take Notice that Edward D. Coffey, defendant above named and the appellant in this action, designates the entire record of this action as the record on appeal and specifically directs that all the records and the files in the Clerk's office pertaining to the above-entitled action are to be included in such records, and among other things such record is to include specifically the reporter's transcript of the evidence introduced on the trial of the cause and all exhibits introduced on behalf of both parties to the action.

Dated at Anchorage, Alaska, this 24th day of May, 1950.

DAVIS & RENFREW,

By /s/ EDWARD V. DAVIS,
Attorneys for Appellant,
Edward D. Coffey.

Receipt of Copy Acknowledged.

[Endorsed]: Filed May 24, 1950.

[Title of District Court and Cause.]

ORDER

Stipulation of counsel for the respective parties having been filed with this Court by the terms of which it is agreed between the parties that appellant may have until the 22nd day of August, 1950, to file and docket the record on appeal in the above-entitled cause, and the Court being fully advised in the premises,

Now, Therefore, it is hereby ordered, adjudged and decreed that appellant may have an extension of time to and including the 22nd day of August, 1950, to file and docket the record on appeal in the above-entitled cause.

It is further ordered, adjudged and decreed that in accordance with such stipulation in the event reporter's transcript has not been delivered prior to the time when the appeal should be docketed in accordance with this order, then the Clerk is directed

to forward the records and files in his office exclusive of the transcript to the Court of Appeals for the Ninth Circuit at San Francisco, California, in order that such cause may be docketed in such Court, and the reporter's transcript may be docketed at a later date after the same has been furnished.

Done In Open Court at Anchorage, Third Division, Territory of Alaska, this 30th day of June, 1950.

ANTHONY J. DIMOND,
District Judge.

United States of America,
Territory of Alaska,
Third Division—ss.

I, the undersigned, Clerk of the District Court for the Territory of Alaska, Third Division, do hereby certify that this is a true and full copy of the Order entered in Journal No. 22, Page No. 120, this 18th day of August, 1950.

M. E. S. BRUNELLE,
Clerk of District Court.

[Seal]: By /s/ CLARA RHODES,
Deputy.

Duly verified.

In the District Court for the Territory of Alaska,
Third Division

Civil Action No. A-5366

ANTONIO POLIMENI,

Plaintiff,

vs.

EDWARD D. COFFEY,

Defendant.

April 17, 1950

Before: The Honorable George W. Folta,
United States District Judge.

Appearances:

STANLEY J. McCUTCHEON, and

BUELL A. NESBETT, of

McCUTCHEON & NESBETT,

Anchorage, Alaska,

Appearing for Plaintiff, and

WILLIAM W. RENFREW of

DAVIS & RENFREW,

Anchorage, Alaska,

Appearing for Defendant.

Whereupon, the following proceedings were had:

PROCEEDINGS

The jury is duly drawn, impanelled and sworn. Opening statement made by counsel for plaintiff, whereupon counsel for defendant waives making opening statement.

BILL SMITH

called as a witness on behalf of the plaintiff, being duly sworn, testified as follows:

Direct Examination

By Mr. Nesbett:

Q. Will you speak into the microphone please.

A. Yes.

Q. State your full name please.

A. William DeVille Smith.

Q. How do you spell that?

A. D-e V-i-l-l-e.

Q. Smith? A. Yes.

Q. Do you know Mr. Polimeni, the plaintiff in this action? A. Yes, I do.

Q. For how long? A. Since 1943.

Q. Where did you meet him? A. Naknek.

Q. Under what circumstances, if you please?

A. Oh, in connection with my flying I have seen Tony around Bristol Bay. He was a cook and fisherman.

Q. What is your business?

A. I have a flying business. I am a pilot.

Q. Are you a bush pilot in the Bristol Bay area?

A. Yes, I am.

(Testimony of Bill Smith.)

Q. Mr. Smith, do you have occasion in your bush piloting to operate in and out of Naknek?

A. Yes, in the summertime I have connections with some of the canneries there and am stationed there.

Q. Do you know whether Mr. Polimeni conducted a business in South Naknek?

A. Yes, I knew him very well.

Q. As a matter of fact you were familiar with his business? A. Yes.

Q. And as a matter of fact wasn't your airplane moored some 200 yards from his business?

A. Yes.

Q. Did you frequent his business?

A. Yes, yes, I did.

Q. Do you know when Mr. Polimeni acquired this restaurant business? A. 1945.

Q. Were you living in Naknek at that time?

A. Yes, in North Naknek.

Q. What was your business at that time?

A. Deputy United States Marshal. [2*]

Q. You had known Tony about three years at that time? A. Yes.

Q. Can you describe that building as of the time Mr. Polimeni acquired it?

A. Yes, a large story and a half building, or two story, a pretty good building—

Q. Pardon me, I asked you to describe it as of the time he acquired it.

A. When he bought it it was only a shell.

* Page numbering appearing at foot of page of original Reporter's Transcript of Record.

(Testimony of Bill Smith.)

Q. Can you state roughly the type of construction in the building?

A. It was a frame building.

Q. Did you have occasion to observe Tony through the next two or three years through his operation of the building and operation in connection with the improvements? A. Yes, I did.

Q. Do you know what improvements he made?

A. Yes, Tony practically rebuilt it, enlarged it and finished it complete.

Q. Do you know how many rooms were in the building?

A. To the best of my knowledge four downstairs and five up.

Q. Do you know the floor area?

A. Yes, the main building was 30x30, and I know there was a windbreak on the front and I believe a porch on the back.

Q. And a half story above? [3] A. Yes.

Q. Did he pour a basement in the building?

A. Yes.

Q. You helped him with the building?

A. Yes.

Q. You knew what was going on in his business?

A. Yes.

Q. He asked your advice before he would make a move? A. Yes, he did.

Q. Now, on or about March 30, 1948, you were in and out of Naknek quite frequently, were you not?

A. Yes.

Q. Would you describe to the court and jury the

(Testimony of Bill Smith.)

state of the building with respect to completion at that time?

A. The building was finished except for the exterior. Tony had hardface brick to finish it. He had lined it with plywood and had new equipment, new kitchen range and full restaurant equipment.

Q. What type business was he conducting?

A. A restaurant and I believe he had a bar and wine dispensary.

Q. Did he do a reasonably good business?

A. Yes, he had actually more than he could handle.

Q. Do you know how long he operated that business?

A. About 30 months to my knowledge. [4]

Q. You know what he did then?

A. Tony went fishing.

Q. What did he do, close his business down?

A. He closed his business.

Q. You know why he did that?

A. Yes, during the summer the canneries——

Mr. Renfrew: Object to that as an opinion.

Mr. Nesbett: I asked him if he knew, Your Honor.

The Court: He may answer, if he knows.

A. Yes, during the summer the cannery feeds its own employees. Tony had an arrangement to feed the employees before the cannery opened. Also there was a large transit trade, but then there was no business during the fishing period.

(Testimony of Bill Smith.)

Q. Have you owned property in Naknek, Mr. Smith? A. Yes.

Q. Are you familiar with property values in that area?

Mr. Renfrew: Object, Your Honor, until it is shown that what he refers to is the town of Naknek, or the cannery site at South Naknek.

The Court: I think he should designate the place.

Q. Are you familiar with property values in North Naknek and South Naknek.

A. Yes, they are identical. I am very familiar with both [5] sides of the river.

Q. Would you state what you consider to be the value of Mr. Polimeni's building and improvements and equipment as of June 1, 1948?

A. That was without the inventory?

Q. Without inventory—building and equipment?

A. Twelve or thirteen thousand dollars.

Q. Do you know what inventory Mr. Polimeni had?

A. It was in excess of three thousand dollars.

Q. How do you know that, Mr. Smith?

A. I helped Tony with several of his transactions and I saw a record of his inventory.

Q. I hand you a copy of the bill of particulars which is on file in this action. Just quickly——

A. But not too quickly.

Q. ——for the reporter would you run down the items on this bill of particulars and state whether or not you knew those items were in the building as of June 1, 1948, and your opinion of the value?

(Testimony of Bill Smith.)

A. You want me to read it?

Q. Just take each item separately.

The Reporter: Would you please get back about six inches from the microphone.

A. Main building, 6 tables \$12.00 a piece, \$72.00. I believe that is correct. [6]

The Court: I think now you are too far away for us to hear you distinctly.

A. One dining table, 4x8, \$45.00. I have seen that and that was worth that. One china closet \$120.00. I have seen that. It would cost that to replace it. Two dressers with mirrors, \$80.00 a piece, or \$160.00. They are worth that. Twelve chairs at \$5.00 a piece, or \$60.00. I think that is conservative. One double bed, spring and mattress at \$80.00. Four three-quarter beds, \$100.00 a piece. I have seen the beds. They were Simmons beds with innerspring mattresses, and I believe that is what they were worth. One cot with a spring and mattress—\$50.00. Blankets, sheets, pillows and cases \$50.00.

Q. Is that too high, or too low?

A. That is a fair valuation, I would say of that. One cook stove \$400.00. I know how Tony bought it. He bought it wholesale through the cannery. It was worth about \$700.00. They transported it for him for nothing.

Q. It would cost the average person \$700.00?

A. \$700.00 to replace it. One hot water tank, 80 gallons, \$39.00. I had seen a bill on that \$39.00. One

(Testimony of Bill Smith.)

automatic electric water pump and pipe \$226.00.
It was worth that.

Q. Did Mr. Polimeni incidentally do anything to that well?

A. Yes, I believe he dug a new well. There had been a well on the property, but I think he dug a new one.

Q. Do you know what that cost? [7]

A. Quite a few dollars.

Q. It is not listed there? A. No.

Q. One light plant \$350.00. I have a light plant myself and I believe that is conservative. One lot of pots and pans \$150.00. I know that Tony had a very good stock of pots and pans.

Q. Would you say he put down too much for those pots and pans?

A. No, he had far in excess of that. He had been gathering pots and pans for years to my knowledge. One lot of crockery dishes \$300.00, and Tony had that many. Had them in stock. One lot of bar and wine glasses for the bar \$80.00, and I know he had more than that because I bought one lot myself for him that was \$50.00. They burned up in the fire. He never used those at all. Personal clothing and gear \$500.00. I know that Tony lost all his clothing, tailormade suits and shirts. He lost everything. Cash and currency burned—buried in the basement, \$2,000.00. I know that he had a lot of cash on hand.

Q. You know where he buried it?

A. Yes, he hid it, stuck in his rolls of siding.

Q. That hardface brick siding?

(Testimony of Bill Smith.)

A. Yes. He had told me previously that he had some money put away. In fact I advised him not to have too much up stairs. [8]

Q. Did you have any interest in that business?

A. No, didn't have any interest.

Q. You have any interest in the outcome of this case? Does it affect you one way or another?

A. No.

Q. Why did you come down to testify? This is your busy season?

A. Yes. Tony is a very good friend of mine and I know he has nothing more. The next is the inventory of food.

Q. Yes. We might as well go briefly through that. Look at it and state whether or not you think it is a conservative inventory?

A. It shows one lot of canned food \$3,047.24. There is a full itemized list.

Q. What is the total?

A. \$3,047.24. There is also beer and wine.

Q. Do you buy your groceries in Naknek once a year for the year?

A. I buy them in Dillingham and——

Q. What do they usually cost you for the year?

A. About \$2,000.00.

Q. For you and your family? A. Yes.

Q. Look at it and state whether or not in your opinion any of them are too large or too small? [9]

A. No, the prices appear correct to me. They are the same prices that I paid. Do you want an inventory of the beer and wine?

(Testimony of Bill Smith.)

Q. Yes, and comments on that inventory. Do you know whether it existed?

A. Yes, I had seen it and helped Tony purchase it, advised him where to buy it.

Q. Would you comment on those items?

A. On this?

Q. No, on the beer and wine.

A. Six cases of bottled beer, \$7.00 a case, \$42.00. \$7.00 that was wholesale. I know he had at least that much. Three cases of Sherry wine \$75.00. He had Sherry wine. I have seen it. Two cases of Claret wine, \$50.00. I have seen Claret wine. Three cases of Port wine, \$72.00. The total so far is \$8,368.24.

Q. Did Tony have a juke box in that room downstairs?

A. I had seen one previous to the fire, however, at the time of the fire I don't know whether it was in there or not. I know he had a combination radio and record player. It was worth \$300.00.

Q. That isn't shown on the inventory?

A. No, it isn't shown.

Q. How do you know?

A. Another fellow there was responsible for it and as Tony [10] didn't have the money I paid for the record player. I paid about \$300.00.

Q. You know what that juke box cost Tony?

A. No, I don't.

Q. Didn't you tell me yesterday?

A. The juke boxes were \$700.00, but I am not sure the juke box was in there when the place burned down.

(Testimony of Bill Smith.)

Q. I am just asking about the value.

A. \$700.00.

Q. Do you know from whom Tony bought this building originally? A. Yes. William Regan.

Q. I believe that was 1945? A. Yes.

Q. When you were Deputy United States Marshal? A. Yes.

Q. Did anyone else to your knowledge claim to own it? A. No.

Q. Were you in South Naknek, or Naknek, on July 20th, 1948? A. No, I wasn't.

Q. Where were you on that date?

A. In Anchorage.

Q. Did you return subsequently?

A. I returned a couple of days later.

Q. Did you have occasion to visit the site where Mr. Polimeni's business was located.

A. Yes. [11]

Q. What did you observe when you went back to that place? A. A pile of ashes.

Q. Did you talk the fire over with the residents of Naknek? A. Yes.

Q. You know whether or not anything was salvaged from that fire?

A. No, there was nothing. Even the sidewalk in front of the building was destroyed.

Q. Was that a wooden sidewalk?

A. Yes, it was.

Q. When did you next see Tony after you discovered the fire had leveled the property?

(Testimony of Bill Smith.)

A. About two weeks later.

Q. You know whether or not Tony had attempted to procure insurance on that property before the fire? A. Yes.

Q. State what you know about his efforts to procure the insurance. What you know and what you heard.

A. I read some of the letters Tony wrote and Mr. Coffey wrote, and Tony asked me—asked my advice several times.

Q. On what points?

A. On the inventory. How to make the inventory up and I know that he was a little perturbed about the slowness——

Q. Did you discuss the fire insurance with him about that time? [12]

A. I discussed this insurance.

Q. I forgot to ask if you believe that total on the inventory is approximately correct?

A. I believe it is conservative, if anything.

Q. Is Tony pretty well known around that area, Mr. Smith? A. Yes, he is very well known.

Q. Is he well liked?

A. He is very well liked.

Q. You know whether or not Mr. Polimeni has a speech impediment?

A. Yes, a very bad one. He is tongue tied and he is deaf also.

Mr. Nesbett: I believe that is all, Your Honor.

Mr. Renfrew: Just a minute, Mr. Smith, I would like to ask you a few questions.

(Testimony of Bill Smith.)

Cross-Examination

By Mr. Renfrew:

Q. How long have you been acquainted with Mr. Polimeni? A. In 1943.

Q. At that time were you located at Bristol Bay?

A. Yes, I fished down there that year.

Q. I believe in response to a question by Mr. Nesbett you stated he asked your advice before he made a move? A. Yes. [13]

Q. Was that condition true for some period of time? A. Yes.

Q. Do you infer that was true from '43 on?

A. Not necessarily. He had asked my advice from 1945. That I would swear to.

Q. Well, with reference to the operation of his restaurant?

A. He had no restaurant in 1943.

Q. No, I thought your answer was that you would swear that he asked your advice in '45?

A. Yes, he did.

Q. Was that with respect to the operation of the restaurant?

A. With respect to the building.

Q. Prior to that time he didn't ask your advice?

A. My advice isn't—

Q. Wasn't he godfather to another pilot—McGregor. Tony bought McGregor an airplane and got his advice until sometime in 1945.

A. Not entirely. I advised Tony not to buy an airplane for McGregor.

(Testimony of Bill Smith.)

Q. He didn't take your advice at that time?

A. I don't think he took anybody's advice. McGregor saw him.

Q. As a matter of fact, Mr. Polimeni isn't fluent in the English language, not merely because of a speech impediment. Isn't that true? He doesn't understand English?

A. No, you are mistaken, Bill. He doesn't understand Italian [14] very well either. I asked some of the Italians year before last and last year too if they could understand him and they said not very well.

Q. You misunderstand my questioning. Isn't it a fact it is almost impossible to understand him in any language?

A. I think I understand him.

Q. You don't have any trouble at all?

A. No more than about fifty per cent of the people, in Bristol Bay.

Q. That don't answer the question, because the jury and the Court are not interested in fifty per cent of the people in Bristol Bay. Do you mean to infer to the jury that you have no trouble in conferring with Mr. Polimeni at all?

A. Yes, I have difficulty. I said he is tongue tied.

Q. Can he write English?

A. Yes, to some extent. He has never written me a letter.

Q. Have you ever seen him write a letter?

A. I have seen him write, but it is a very painful process.

(Testimony of Bill Smith.)

Q. You have seen him attempt to write, but could you read what he wrote?

A. Yes, what he wrote I could read. I have seen him write his name and I can read that.

Q. Can he read English? A. Yes.

Q. If he picks up a newspaper he can understand it? A. He understands most of it. [15]

Q. Is he sufficiently fluent in the reading and writing of English to be able to read a newspaper?

A. Tony was granted citizenship and I believe that is one of the requirements.

Q. Regardless of the requirements of citizenship, you have been acquainted with him a good many years and been his advisor, would you say he can read a newspaper and write—say he can write a little?

A. I know he can read. I don't know how well he can write. I have seen him write a little bit.

Q. What time in 1945 did he open the restaurant, if you know?

A. In March. It might have been previous to that.

Q. This was in the year '45?

A. No, no, it was in '48.

Q. Do I understand the restaurant had never been opened by Polimeni prior to March, 1948?

A. Not to my knowledge.

Q. You had been there since '43, hadn't you?

A. Yes.

Q. You would know if it was operated prior to the spring of '48?

(Testimony of Bill Smith.)

A. Yes, I should have known. I didn't do too much business in South Naknek until '45. I was on the other side of the river.

Q. So far as you know this restaurant started to operate in [16] the spring, probably in the month of March, 1948? A. Yes.

Q. Where did Mr. Polimeni get his supplies to open that restaurant?

A. From the sources—from the Alaska Packers in South Naknek and a lot from Anchorage, had them flown in.

Q. I believe you stated you had helped him make purchases? A. Yes.

Q. And you were sufficiently well acquainted with his provisions to state that he had that on hand?

A. I wasn't familiar with every kind.

Q. I understand you to say this inventory was very conservative.

A. My inventory at home runs about \$2,000.00.

Q. Were you judging your own inventory here, or his inventory from your personal knowledge?

A. I know what he had to a large extent, and I also know what was necessary in Bristol Bay.

Q. If you know what he had to a large extent I want you to state how you know what he had to a large extent.

A. I talked over some of his purchases from the Alaska Packers Associated. They advanced him a large amount of goods on credit and in return he fed some of their men.

(Testimony of Bill Smith.)

Q. Allright that would be in consideration of his feeding their men, wouldn't it? [17] A. Yes.

Q. He fed their men and then closed the restaurant?

A. No, he didn't close it immediately.

Q. It was closed at the time of the fire?

A. That is correct.

Q. In the interim he fed their men?

A. That was only part of his business.

Q. But it would be a reasonable presumption that they ate up the stuff that was furnished by the cannery.

A. Part of it. They didn't get all the supplies from the cannery. The cannery furnished them material and they wouldn't eat that up.

Q. Do you have any personal knowledge of what was in the restaurant at the time of the fire?

A. Yes.

Q. What is that based on?

A. Shortly before the fire Tony conducted me very proudly through the whole building.

Q. Can you give the exact date?

A. No, I can't. I made a trip outside to get a new plane and when I got back Tony showed me.

Q. Do you recall when you got back with your new airplane?

A. No. I have the record in Dillingham.

Q. Unfortunately, we can't wait until you can hear from Dillingham. You don't often go out and get a new airplane. [18]

A. I have the last two years.

(Testimony of Bill Smith.)

Q. Can you estimate?

A. I think it was the latter part of May or the 1st of June.

Q. When does the fishing season open?

A. About the 1st of July.

Q. Do you know when he closed the restaurant there?

A. It was about the middle of June.

Q. Isn't there more than one fishing season?

A. Yes, there are three fishing seasons. When the ordinary persons speaks it is of the red run, but there is also the King Salmon and Tony went to another river for King Salmon.

Q. When was that, about the latter part of May or June 1st you looked through his establishment?

A. Yes.

Q. When had you been there previous to that?

A. I don't know. I had been in the Bristol Bay Area some time.

Q. I understood from your testimony you had just returned from a trip to the States?

A. Yes.

Q. How long were you away?

A. About a month.

Q. So then I take it there was about a month prior to the time he took you through there that you hadn't been there at all?

A. That is correct. [19]

Q. You went into it just once?

A. Several times a day.

Q. Going through and counting the inventory?

(Testimony of Bill Smith.)

A. Yes. I ate there and I was through the building. There was no barber and Tony cut my hair.

Q. Were you there the day he closed it up?

A. No. I was in South Naknek, but wasn't in his building.

Q. Do you know how long prior to the time he closed it up that you were in the place? Understand what I mean?

A. Yes. It would only have been two or three days.

Q. After you returned from the States you were a boarder with Tony?

A. No. I ate at the cannery some of the time and with Tony to give him the money—the business.

Q. That is an amphibious craft? A. Yes.

Q. Your place was across the river?

A. I was stationed in South Naknek.

Q. You flew a Seabee? A. Yes.

Q. That is an amphiibous craft? A. Yes.

Q. Didn't you keep that down on the water there? A. Yes.

Q. The tide there is one of the best in Alaska? [20]

A. Yes.

Q. How often does that tide come in?

A. A couple of times a day. As you say the Seabee was amphibious and it was above the high-water mark.

Q. You were flying it as much as possible?

A. Yes.

(Testimony of Bill Smith.)

Q. So you really didn't have time to inventory Tony's stuff? A. No.

Q. You are at this time giving what you consider a rough estimate of what you thought Tony had?

A. Yes, but as I said before he had a lot of possessions that wasn't on this.

Q. You didn't make up this bill of particulars?

A. No, I didn't.

Q. And you understand this was furnished by the plaintiff in this case? A. Yes.

Q. To advise us what he lost?

A. Yes, I had a list at the time he applied for insurance and I also saw this.

Q. Did you assist him in his application for insurance, Mr. Smith?

A. I read the letters and told him they were all right.

Q. You mean the letters that he wrote?

A. They were written for him. [21]

Q. Who wrote the letters for Mr. Smith, or Mr. Polimeni, excuse me?

A. I know that the school teacher wrote a couple of them.

Q. Do you know anybody else that wrote for him?

A. Yes, the storekeeper, or bookkeeper at the cannery.

Q. It is my impression from your testimony that you tried to infer that after he would go to the school teacher or the bookkeeper at the store he came around to ask you if the school teacher or book-

(Testimony of Bill Smith.)

keeper were doing alright? A. Yes, he did.

Q. Are either of those people here to testify?

A. No.

Q. You have stated that the valuation on one side of the river is identical with the valuation on the other side of the river. You don't really mean that?

A. Well, I don't know. If you buy lumber to build a place on one side it costs the same.

Q. Isn't there a population in North Naknek that supports a store and other business?

A. No, there is only one store in——

Q. I am speaking of conditions in '48, at the time of this fire. A. Yes.

Q. Isn't it true there were three grocery stores in North Naknek and none in South Naknek, except the cannery? [22]

A. No, you are wrong. There were only two stores, one that was in the process of going out of business. However, the cannery in South Naknek is a large store, and supplies the people in the whole territory. There are an equivalent number of people in South Naknek as well as North Naknek.

Q. On what do you base your claim of value as of June, 1948, of \$13,000.00, on what do you base that, Mr. Smith?

A. Well, I figure his building was worth about \$10,000.00 and I believe he had at least a couple thousand dollars worth of stock in it. I had talked to the cannery superintendent about it.

(Testimony of Bill Smith.)

Q. Let's take the building. You say he purchased the building in '43, I believe from Billy Regan, the former Commissioner there?

A. Bill Regan was the Commissioner.

Q. You say he purchased the building from him in 1943? A. I didn't say '43.

Q. I misquoted you then. What year was it?

A. Well, Bill Regan and Tony talked over the purchase of the building I think in '45.

Q. Do you know when he purchased the building?

A. The purchase was a long drawn out affair.

Q. If you know about it, please tell me, Mr. Smith. You inferred you were consulted?

A. You asked me the question. [23]

Q. Alright, what do you know about Mr. Poli-meni's purchase of this building in '45?

A. I know he made a deal with Bill and Bill was satisfied with the deal, but the whole deal was not consummated then. I even know what you want me to say, but you can ask me and I will answer it.

Q. I will ask you what I want to to see if you know? A. You ask me.

Q. I just did. We are not here to waste time. Let's not banter each other, let's get down——

A. The entire deal was not consummated then, but part was consummated at a later date after Bill Regan's death.

Q. Do you have any knowledge as to what the deal was? A. Yes.

Q. Will you state what the deal was.

(Testimony of Bill Smith.)

A. I don't think it has too much bearing on this.

The Court: The witness should answer each question, unless there is an objection and it is sustained.

Mr. McCutcheon: To state what a long drawn out deal is isn't—

A. He hasn't asked me the question.

The Court: When the question is asked this Court will rule on it.

Q. Mr. Smith, the question I am trying to ask you is quite simple. I want you to tell the Court what the deal was between [24] Mr. Polimeni and Mr. Regan?

Mr. McCutcheon: Objected to. It has no bearing on this case.

Mr. Renfrew: This is cross-examination and it was brought out.

The Court: You may answer.

A. Bill Regan and Tony had talked over with me in my house in '45 Tony's purchase of the shell, the frame of the building, from Bill Regan and Bill Regan owed Tony a considerable amount of money and Tony was to get the building for the debt. At the time of Bill's death his assets were all mixed up. He was administrator for several estates and I don't believe all these were settled until this day. He was also in with the Alaska Packers Association and their records were mixed up so Tony's deal was also mixed up. Hal Marchbanks succeeded Regan as Commissioner, and in order to clarify the whole thing he sold the building to Tony.

(Testimony of Bill Smith.)

Q. That has been quite lengthy. Now, tell us what he sold it for?

A. I don't know for sure.

Q. Did he ever pay for it?

A. He paid part of it and Marchbanks told him he didn't have to pay the rest of it.

Q. As a matter of fact the ownership of that building was involved in an estate which Regan was handling as Commissioner? [25]

A. Regan told me in '45 that as U. S. Commissioner he owned the building.

A. As I said his affairs were all mixed up.

Q. You have never seen a deed or bill of sale?

A. I don't think there is a deed to any of the property in Naknek, except the cannery property.

Q. Have you seen one?

A. I have not seen one.

Q. Do you know how much money Tony paid for it?

A. I know approximately and as I said he only bought the shell.

Q. Yes, but do you know how much money he paid?

A. For what he bought he paid Marchbanks, I believe, I am not sure, \$1200.00.

Q. You mean he agreed to pay \$1200.00?

A. Yes.

Q. But only paid a portion of that?

A. Yes.

Q. That was in '45? A. No.

Q. What year was that?

(Testimony of Bill Smith.)

A. I believe that was '48.

Q. Now give us an estimate whether it was January, February or March?

A. I don't know. Bill died in the spring. I believe he died [26] in 1946, and it was a few months later that Tony bought it.

Q. That was in '46 then?

A. I am not sure.

Q. Well, upon what do you base the value of the building at \$13,000.00, or the portion of the building that was not included in equipment. I think you said about \$2,000.00 worth of equipment, so that would be \$11,000.00.

A. I know what the building would be worth and I also know the amount of material Tony put in it and what he bought.

Q. What did he buy to put in it? That is what I am trying to get from you.

A. This is a very complicated deal.

Q. Not more complicated than the last one?

A. No. The Alaska Packers decided to destroy Bill Regan's home. It was an old building on their property, and they told Tony that if he tore it down he could salvage it. So Tony hired men and paid them to tear the building down, and he also bought considerable material from the Alaska Packers.

Q. Then the value over what he paid for the labor would be the salvaged lumber?

A. No. He got other material. He bought brick siding from the Naknek Trading Company, I believe. I know he bought plywood.

(Testimony of Bill Smith.)

Q. Those facts could all be substantiated from the invoices? A. Yes, they can. [27]

Q. Alright, Mr. Smith, you said you helped him purchase these supplies. I suppose you mean you gave him advice? A. Yes.

Q. I will ask you whether or not you ever saw any invoices for these supplies?

A. I saw some of the invoices.

Q. Does he have them?

A. His building burned down and he had most of his records in it.

Q. Did you ever advise him to go back to the people he bought the stuff from and get copies?

A. Yes.

Q. Did he do that?

A. I went to the Alaska Packers Association. His bill with them for that spring was between five and six——

Q. Just answer my question.

Mr. Nesbett: I object. He is doing his best.

The Court: He may be doing the best he can but he is not answering.

A. As I told——

The Court: Of course, it is impossible to educate every person to answer questions in the brief time they are on the stand.

answer. [28]

The Court: You should qualify your answer after you make the statement, but not before.

Q. The question is did you get the invoices, or

(Testimony of Bill Smith.)

do you have them? A. No. Can I qualify?

Mr. Nesbett: Your Honor.

The Court: I have already told him that he could qualify his answer, or explain his answer.

A. I went to the Alaska Packers Association in the spring of this year in Seattle and asked for the invoices for Tony and they told me it would be a very long drawn out process since their bookkeeping was set up so they could not put their fingers on it, but if it became necessary in the future they could probably do so.

Q. What about the other people; the Naknek Trading Company?

A. I didn't go to the Naknek Trading Company.

Q. In other words, you limited your inquiry to the one you mentioned?

A. Yes, the Alaska Packers.

Q. And you did not get copies of the invoices?

A. No.

Q. Do you know how long the premises were vacant, or whether they were vacant at all prior to the fire?

A. Yes, they were vacant for a short period prior to the fire.

Q. I will ask you if you could state approximately the length [29] of time they were vacant prior to the fire? A. Approximately, yes.

Q. Will you do so?

A. Ten days approximately.

Q. Then, if the fire occurred on the 20th, you

(Testimony of Bill Smith.)

don't think the premises were occupied after the 10th of July, I think it was?

A. It is approximate. I am not sure.

Q. A little while ago you mentioned that Tony went fishing for the King Salmon and that that season opened on the 15th of June?

A. No, I didn't say the 15th of June.

Q. Maybe my recollection is wrong.

A. I said approximately. I don't know the dates exactly.

Q. If he left approximately the 15th of June and the fire didn't occur until the 20th of June and you feel the property wasn't vacant can you say who stayed there?

A. Al Rule and Hansen and a couple of other people operated the premises.

Q. Were they operating on a share basis, or something? A. Yes.

Q. What are their names?

A. Alfred Rule.

Q. Who else? A. Nan Hansen. [30]

Q. Are they here to testify?

A. Mr. Rule is here.

Q. Now, you have confined your testimony to a building, Mr. Smith, was there more than one building destroyed by this fire? A. No.

Q. Isn't it true that Mr. Polimeni had more than one building in conjunction with his operations there?

A. Yes, but I would like to qualify that statement, if I may.

(Testimony of Bill Smith.)

Q. I don't see how you can qualify it.

Mr. Renfrew: If the answer is yes, Your Honor, it doesn't give me a chance to go on and ask any more questions. How can you qualify the fact that——

Mr. Nesbett: Maybe Mr. Renfrew knows the answer, but I don't like the way he quarrels with the witness.

The Court: Of course, it is impossible for the Court to determine what he has in his mind.

Mr. Nesbett: Will Your Honor give him the opportunity?

The Court: Yes. He may have the opportunity.

A. Tony had a small privy and a small shed.

Q. I will ask you whether or not one of these buildings which was destroyed by the fire was for housing the light plant?

A. It was for housing the light plant?

Q. Yes. Wasn't one of these small buildings the one that had the light plant in it? [31]

A. It did not have the light plant in it. It was built for the light plant.

Q. Was the light plant ever in there?

A. Not to my knowledge. I saw it running on the back porch.

Q. Then you would say that a building approximately eight by ten feet was not used for housing the light plant?

A. It was built for housing the light plant.

Q. It was not used—housed is the word I used?

A. Not to my knowledge.

(Testimony of Bill Smith.)

Q. Do you know wether or not it was?

Mr. Nesbett: Quarrelling with the witness again, Your Honor.

The Court: He didn't say it in an affirmative way, but in a negative way. If he says it is not to his knowledge I don't see how you can pursue that inquiry any further.

Mr. Renfrew: Maybe I misunderstood him, Your Honor, but this witness is very reluctant to——

Mr. Nesbett: If the witness is reluctant it will be obvious to the jury.

The Court: You may proceed and ask your next question.

Q. Mr. Smith, a moment ago you stated that the light plant was not in this building, but the building was put there for the purpose of housing the light plant? A. Yes. [32]

Mr. Nesbett: If he said it. All he can ask is did he so state.

The Court: He can restate it in his own words. Objection is overruled. You can recite the testimony as counsel understands it.

Mr. Renfrew: I will restate it so you can correctly understand what I am trying to elicit from Mr. Smith.

Q. I understood you to testify a few minutes ago that this building was erected for the purpose of housing the light plant, but the light plant had been on the back porch of the house? A. Yes.

Q. And then you said to the best of your knowledge it was not in the shed? A. Yes.

(Testimony of Bill Smith.)

Q. Do you know positively whether it was in the shed or not? A. No, I don't know.

Q. Then do you know whether or not it was destroyed by the fire? Did you ever look in that shed after the fire?

A. Not immediately following the fire.

Q. Do you know how long it was after the fire before Mr. Polimeni got down to Naknek?

A. It was only a few days.

Q. By a few days you mean more than two and less than a week?

A. It was approximately a week. [33]

Q. Do you know who looked after his equipment or what he had around there during that interim after the fire?

A. He had nothing left that was worth anything to my knowledge.

Q. Do you know whether or not Mr. Rule or Mr. Hansen had anything to do with looking after his affairs while he was gone? A. Yes.

Q. Well, did they? A. Yes.

Q. There was another building about six by eight which was approximately twenty feet from the main building, and it was made into separate rest rooms with shields for entrances. That was not destroyed either was it? A. No.

Q. You have no personal knowledge, do you, Mr. Smith, of any of the transactions between Mr. Polimeni and Mr. Coffey, other than the letters which you read and concerning which he sought

(Testimony of Bill Smith.)

your advice about which you have previously testified, is that right?

A. Well, there is something further. There could be more.

Q. That you and Mr. Polimeni prior to the time he had the fire did you have any further discussion with him concerning this insurance other than what you have testified?

A. He talked to me about it almost every day.

Q. He talked to you about his insurance almost every day before the fire?

A. When he could catch me.

Q. When did he start talking to you almost every day?

A. After he showed me his building. Tony has been in the habit of asking me, as I said before, for years and when the people tell him something he comes to me and asks me if it is correct.

Q. Was your conversation—were your conversations limited to merely advising him that he should have insurance? A. No.

Q. What with reference to these letters, Mr. Smith, did you ever write anything for him in connection with the application?

A. No. I didn't have time to make an inventory for Tony, but he showed me the inventory and asked me if they were correct and asked me if to my knowledge they would be acceptable.

Q. You have reference to his letter of April 17th. Are you familiar with that?

(Testimony of Bill Smith.)

A. I don't remember the date, but I read the letter with the inventory in it.

Q. Did you see a letter with the inventory in it?

A. I saw an inventory and I recall letters.

Q. Did you ever see a letter addressed to the Coffey Agency that contained an inventory?

A. I seen the same letters that you have here. [35]

Q. You saw them in Mr. Nesbett's office, didn't you? A. Yes and I saw them before.

Q. When he received them?

A. Approximately the same letters.

Q. I inferred from your testimony a few moments ago that an inventory which Mr. Polimeni sent Mr. Coffey——

A. I saw an inventory and he told me he was going to mail it. I don't know whether he did or not.

Q. Was that the extent then of your conversation with him that the inventory would be right and that you approved the letters he wrote?

A. Yes.

Q. So far as you know that is all you know about his request and application for insurance, just what those letters show and that you advised him that the letters were right? A. I suppose so.

Q. If there is anything else that you could help the jury with you are at liberty to do so.

A. I cannot recall anything that would be pertinent.

Mr. Renfrew: I think that is all.

(Testimony of Bill Smith.)

Re-Direct Examination

By Mr. Nesbett:

Q. What do you mean there might be more, Mr. Smith, are you [36] referring to the receipt that I mentioned? A. Yes.

Q. Tell them about it. You talked to the school teacher up there, didn't you?

Mr. Renfrew: Objected to as hearsay.

A. You wanted to know about it. You will get it. From what Mr. Polimeni told——

The Court: Counsel has a right to object to anything based on hearsay no matter what he asked, unless he asked for the hearsay, and he hasn't done that.

Q. Did you cause me to commence a search for a certain receipt that was alleged to have been signed by Coffey? A. I didn't understand——

Mr. Nesbett: Will the reporter read the question, please?

The Reporter: Did you cause me to commence a search for a certain receipt that was alleged to have been signed by Coffey?

Q. The answer? A. Yes.

Q. You know whether or not I wrote letters and made certain attempts to locate that receipt?

Mr. Renfrew: Object to this as self-serving and also hearsay. If Mr. Nesbett would like to testify I wouldn't object to that, if he wants to take the oath. [37]

(Testimony of Bill Smith.)

Mr. Nesbett: I will drop it, Your Honor. I assumed that he wanted to know.

The Court: I assume that he wanted to know by other than hearsay.

Q. Mr. Smith, you have never had any financial backing from Mr. Polimeni?

A. No, I haven't.

Mr. Renfrew: Object as improper re-direct and has no bearing at all.

The Court: It is improper re-direct unless you ask for permission to ask the question.

Mr. Nesbett: Your Honor, the question was on cross-examination "Did Tony ever buy an airplane for you?" A. No, he never did.

Mr. Nesbett: I think I have a right to go into that again.

The Court: You have a right to go into everything he brought out on cross, but I thought you went into this on direct.

Mr. Nesbett: Yes, but Mr. Renfrew says did he ever buy an airplane for you.

The Court: If it is anything new in addition to what has already been gone into, yes.

Q. I asked if you ever received any backing?

A. No, I have never received one penny from Mr. Polimeni. [38]

Q. Now, do you know whether or not Mr. Polimeni was employed by Mr. Regan the owner of this building that burned? A. Yes.

Q. You know how long Mr. Polimeni worked for him? A. For a period of several years.

(Testimony of Bill Smith.)

Q. You know whether or not Mr. Regan paid him for his work? A. No, he didn't.

Q. What was the arrangement between Regan and Polimeni, if you know?

A. Mr. Regan had several children and his wife was dead, and as Tony had no work in the winter he did the cooking.

Q. Was he to receive anything as compensation for that work? A. Yes.

Q. How much? A. I don't know.

Q. Do you know whether or not he ever received anything for that work?

A. I don't know. I know he and Bill discussed it.

Q. You know whether or not he was allowed anything for that as payment on the building?

A. Yes.

Q. How much?

A. Bill Regan told me he was going to——

Mr. Renfrew: Object as hearsay.

The Court: Sustained. It is objectionable [39] as hearsay.

A. They both told me——

The Court: It would still be hearsay. If you have any personal knowledge you may state.

A. They talked over the arrangement with me in my office when I was marshal.

Q. Then you know? A. Yes.

Q. What was it?

A. There were two arrangements. First Tony

(Testimony of Bill Smith.)

and Bill were to be partners and later Tony was to have the building.

Q. Under what conditions?

A. As payment for services to Regan.

Q. Did Mr. Polimeni get the building?

A. Not from Regan.

Q. Who did he get it from?

A. Marchbanks.

Q. Regan died before the deal was ever completed?

A. Yes.

Q. Has anyone in Naknek ever objected to Mr. Polimeni's ownership?

A. Not to my knowledge.

Mr. Renfrew: Objection—out of the scope of this man's knowledge.

The Court: It is immaterial. Didn't have [40] any value.

Q. Where was this other building that Tony got? Where was it located in South Naknek?

A. I know, but I have forgotten now.

Q. Was it adjacent to the building that burned, or near there?

A. No, he moved it to that site.

Q. Then what did he do?

A. I don't quite understand.

Q. With reference to the building you say Tony hired men and tore it down to use the material?

A. He used what he could.

Q. Did the material from that building go into the building that he subsequently built?

A. Yes, what he could use.

(Testimony of Bill Smith.)

Mr. Nesbett: I believe that is all.

Mr. Renfrew: Just one more question, Mr. Smith.

Re-Cross-Examination

By Mr. Renfrew:

Q. You know whether or not the building which is the original building here and the original shell I believe you stated purchased from Marchbanks who acted as Administrator for Regan, was that building—did it belong to Regan or did it belong to an estate? [41]

A. Anything I could say at this point would be hearsay.

The Court: If it is hearsay you won't be able to answer.

Q. Of your own knowledge you don't know?

A. I know so far as I can know without seeing a deed.

Q. You stated a few moments ago that there were never any deeds in Naknek, I believe?

A. I haven't seen any.

Mr. Renfrew: That is all, Mr. Smith. Thank you very much.

The Court: The Court will now be in recess for ten minutes.

(Whereupon, court is recessed for ten minutes, and at 3:40 p.m. the following proceedings are had:)

The Court: You may call your next witness.

Mr. Nesbett: Mr. Kenneth Shipley.

KENNETH SHIPLEY

called as a witness on behalf of the plaintiff, having been duly sworn, testified as follows:

Direct Examination

By Mr. Nesbett:

Q. State your full name, Mr. Shipley.

A. Kenneth Wrigley Shipley. [42]

Deputy Clerk: What is the middle initial?

A. Wrigley.

Deputy Clerk: Shipley? A. Yes.

Mr. Renfrew: What is the last name?

Mr. Nesbett: Shipley. S-h-i-p-l-e-y.

Q. What is your business, Mr. Shipley?

A. Primarily fishing.

Q. You know Mr. Polimeni?

A. I have known Mr. Polimeni since 1938.

Q. Where did you meet him?

A. At South Naknek, Alaska.

Q. Have you had occasion to work for Tony Polimeni after you met him?

A. Yes. I worked for him lots of times.

Q. I will ask you if you helped him on the building? A. I started that myself.

Q. What did you do?

A. Worked on the basement and went up with the work.

Q. What did you do with the basement?

A. We have a full basement. It is a thirty by thirty basement. We had a 34 foot well. It was all cased and lined and later the well was sunk down to 60 feet.

(Testimony of Kenneth Shipley.)

Q. Who did that work?

A. Some of the boys working around South Naknek. [43]

Q. Were they employed by Tony?

Mr. Renfrew: I object to the questions unless the witness knows by his own knowledge.

The Court: I think they are in order.

Mr. Renfrew: Very well, your Honor.

Q. I asked what you did in the basement. Would you state what was done there.

A. The basement was lined with redwood planks.

Q. What size planks?

A. It comes about three by twelve.

Q. Did you do that work? A. Yes.

Q. What else was done in the basement?

A. First the well and lined that up.

Q. What other work did you do for Mr. Polimeni?

A. Well, wait a minute. The question is wrong there because I was working for Bill Regan to start the building.

Q. That is when you built the basement. Is that right? A. Right.

Q. After you commenced working for Mr. Polimeni what did you do on that building? What was your first job?

A. I didn't work for him so much after that. He used another—a carpenter.

Q. Didn't you assist Mr. Polimeni in fixing this building up? [44] A. Yes.

Q. What did you do?

(Testimony of Kenneth Shipley.)

A. Well, we started out first with the basement.

Q. What did you do in the nature of completion of the basement?

A. Well, put in the stairs and all—just odds and ends of work that you do to fix any building.

Q. Did you construct a stairway from the basement up to the first floor? A. Yes.

Q. What else did you do?

A. Well, it is pretty hard to say.

Q. Well, did you do any insulation work on the building?

A. The building was sealed with Masonite and then on top of the Masonite came the plyboard.

Q. Was the first floor done that way?

A. Yes.

Q. The first floor?

A. The first floor was a double floor laid two by twelves. They figured on dancing there and the timbers they put in there was twelve by twelve.

Q. Was a double floor put on the first floor by Mr. Polimeni?

A. No, that was the original floor of the building.

Q. How many rooms were there on the first floor? [45]

A. There was four.

Q. Were all of those rooms constructed as you stated previously with Masonite and plyboard?

A. Yes.

(Testimony of Kenneth Shipley.)

Q. Was there any other work done on those four rooms by you or Mr. Polimeni while you were there? A. Did I install——

(Interruption)

Mr. Renfrew: Just a moment. Now, your Honor, the question has been asked of the witness.

(Interruption.)

A. What I was trying to figure out was where my work stopped and the other boys took over, because about that time I got a winter maintenance job with the cannery and after that well then the reason I know about the material is I had to check it out of the cannery and haul it up myself.

Q. What materials were used?

A. Plyboard and Masonite and all this furring and most everything—most everything you use to build a house.

Q. What was done on the second floor?

A. Mr. Polimeni hired a couple of carpenters to complete the second floor. That was cut up into five rooms. That was Masonite and plyboard on the walls and plyboard on the partition walls.

Q. You know whether or not Mr. Polimeni furnished those rooms [46] after that was completed?

A. I was in a couple of them. A friend of mine was staying there. There was a bed and dresser and what not.

Q. Each room?

A. The ones I was in. They was divided. A lot of material that was supposed to be used that was stored in a couple of the rooms.

(Testimony of Kenneth Shipley.)

Q. You know whether or not there was material stored in the basement?

A. I cannot say positively. That was hearsay. I know he was going to get that imitation paper, or imitation brick for the outside walls, but I never saw it, but that can be checked by the cannery records very easily.

Q. You still live at Naknek, Mr. Shipley?

A. Yes.

Q. Have you lived there all this time?

A. No, I was outside. I went back home.

Q. When did you last work for Mr. Polimeni on this building? A. That would be '48.

Q. 1948. What month?

A. That would be just before it opened.

Q. Just before it opened?

A. Yes, because I was working a gang down there and I used to bring boys up there to feed and Tony was feeding the cannery gang that I had working that spring. [47]

Q. Would you say you quit working for him in May? A. Before I left.

Q. In April? A. Yes.

Q. How long had you worked for him prior to that?

A. Off and on you might say for three or four years. I would work a few days or so when he needed me, or when I was available for the job.

Q. I believe you testified, did you not, that you met Tony in 1938 for the first time?

A. 1938, yes, sir.

(Testimony of Kenneth Shipley.)

Q. You were living in the Bristol Bay Area at that time? A. Yes.

Q. In South Naknek or North Naknek?

A. Yes.

Q. South Naknek?

A. Yes, in 1939 I bought my own home there.

Q. Are you familiar with property values in South Naknek at that time? A. Yes.

Q. Would you state your idea of the value of the building along about the time you quit work for him?

A. I imagine from what I saw it would take between eight and ten thousand dollars to duplicate that building.

Q. For just the building? [48]

A. Yes, with the material that went into it.

Q. Are you able to estimate the value of the fixtures in the building less the value of the merchandise?

A. Well, I never saw any bills on the finances and all that. It is not for me to say.

Mr. Nesbett: I believe that is all, Your Honor.

Cross-Examination

By Mr. Renfrew:

Q. Mr. Shipley, you stated you worked various times over period of years for Mr. Polimeni?

A. Yes.

Q. Was all that work confined to this building, or did you do other work not on the building?

A. Well, when he was tearing down that old building, being a representative of the company, I

(Testimony of Kenneth Shipley.)

don't loan any trucks out. I did all the work myself. The same with the cat. I would take the cat or the truck and go ahead.

The same with the cat. I would take the cat or the truck and go ahead.

Q. Outside of the time when you were working for the company I am asking whether you during that two or three year period of what interval you worked did you work on this building or did you do other work for him?

A. No. Most of my work consisted of around that building.

Q. Then I take it you were working on that building for [49] three or four years.

A. I was.

Q. But a part of the time you were working for Mr. Regan, the owner of that building.

A. To start with I was working for Regan.

Q. When did Mr. Regan pass away, do you know? A. Forty-six I think it was.

Q. Prior to that date did Mr. Polimeni claim any interest in that building. A. No.

Q. Then you couldn't have been working for him for two years, could you, because if Mr. Regan passed away in forty-six and Polimeni didn't claim anything there until he passed away that would have been it? A. Two years?

Q. All I want are the true facts of the situation, Mr. Shipley. In the aggregate how many days do you suppose you were employed by Mr. Polimeni on that building?

(Testimony of Kenneth Shipley.)

A. Well, to be frank with you, I couldn't say. I would have to check up on the books.

Q. Would you give us just a rough estimate as to whether it would be ten days, or two months, or twelve months?

A. I didn't make any statement. Lots of time I worked for Tony when I was working for the company, and that wouldn't be on record. [50]

Q. You mean you were getting pay checks from two outfits? A. Yes.

By the Court: If you remember——

A. To be frank with you, I cannot tell you exactly how much money I did make from Tony.

Q. Would you make an estimate. You know whether it was a thousand dollars, or two hundred dollars, or three hundred dollars, don't you?

A. Call it three hundred dollars.

Q. Would you state that it could be five hundred dollars and could be two hundred dollars?

A. Three hundred dollars would be a very fair figure, I would say.

Q. That would be all the work that you did for him over the entire time, the two years?

A. Yes.

Q. As I understand your testimony, Mr. Shipley, you were in charge of some portion of the cannery, so that what Mr. Polimeni purchased had to be checked out through you, say this ship lap and Masonite and some other building materials?

A. Yes.

Q. I will ask you if when it was checked out

(Testimony of Kenneth Shipley.)

through you an invoice was made for that purchase was it not?

A. That was made by the storekeeper.

Q. There was an invoice. That is a permanent record? [51]

A. Oh, yes.

Q. So that we could easily determine from those records what Mr. Polimeni did buy?

A. Yes, sir.

Q. Do you happen to have them?

A. As I stated, I came in from outside and I didn't know anything about this case until I got here to Anchorage.

Mr. Renfrew: Right. Thank you Mr. Shipley.

Re-Direct Examination

By Mr. Nesbett:

Q. Mr. Shipley, Tony did pay you for that work?

A. Yes. Tony don't owe me a thing.

Q. Tony paid the other carpenters around there too, didn't he.

Mr. Renfrew: Object to that. It is not proper re-direct.

The Court: Unless you consider it vital to your case, and ask for permission to ask this particular question, objection will have to be sustained.

Q. At the time you were working for Tony and also at the cannery were you employed as the winter man? A. Yes.

Q. Your duties in that line are not definitely defined except to keep track—— [52]

(Testimony of Kenneth Shipley.)

Mr. Renfrew: Objected to——

The Court: Will you repeat that, please.

Mr. Nesbett: I will rephrase it, Your Honor.

Q. What were your duties as winter man?

A. The winter man takes care of the cannery and puts it away for the winter and maintains the light plant. The light plant goes on at 4 o'clock in the afternoon and off at midnight, and you pump oil and everything else, just like any other city. It is just like a little city.

Mr. Nesbett: No further questions.

Mr. Renfrew: We have nothing further.

Mr. Nesbett: That is all, Mr. Shipley.

Call Mr. Albert Ruhl.

ALBERT RUHL

called as a witness on behalf of the plaintiff, having been duly sworn, testified as follows:

Direct Examination

By Mr. Nesbett:

Q. Is Albert Ruhl your full name?

A. Albert Henry Ruhl.

Deputy Clerk: Henry? A. Yes.

Deputy Clerk: R-u-h-l? A. Yes. [53]

Q. Where do you reside?

A. At the present time North Naknek.

Q. How long? A. Six years.

Q. Have you ever lived in South Naknek?

A. Yes, I have lived in South Naknek.

Q. When did you live there?

A. Up until August of 1948.

(Testimony of Albert Ruhl.)

Q. You know Mr. Polimeni, the plaintiff in this case? A. Yes.

Q. How long?

A. I have known Tony since 1944.

Q. Are you familiar with the restaurant and cocktail bar that Tony owned at South Naknek?

A. Yes, I am.

Q. Did you have occasion to work on that building for Tony?

A. Yes in the spring of forty-eight I helped him get the place ready for operation.

Q. Had you worked on that building previously?

A. No.

Q. Do you recall when you went to work in the spring of forty-eight?

A. I came back from the States the 2nd day of February. I was hospitalized and I started immediately working for Tony when I came back. [54]

Q. That would be what date?

A. About the 4th or 5th of February.

Q. Were you with Tony in South Naknek right up until the time the building burned?

A. Yes, I was.

Q. Can you describe to the Court and jury briefly the type of construction used in that building?

A. Well, I didn't have so much to do with the construction work, the carpenter work. He had that done in the summer time. I was also a winter man in the cannery. I know he had four carpenters awhile, and also one working all summer.

(Testimony of Albert Ruhl.)

Q. You know that of your own knowledge?

A. Yes.

Q. You were there frequently?

A. I was living there.

Q. In the building? A. Yes.

Q. Then state what was done there, even if you didn't do it.

A. He used mostly all new lumber. He did buy an old house from Regan, but the place was torn down with a cat and torn up and very little he could use. He built a large windbreak on the back. I think that windbreak was about eighteen feet long and seven or eight feet wide, and a windbreak on the front. He put all new windows up stairs. Tore the roof off the place and put in gables on the roof in order to build rooms up stairs. [55]

Q. What do you mean?

A. The roof was a pitched roof and I had to tear it off and raise it up in order to put windows in the rooms.

Q. Go ahead.

A. That was all insulated up there and plywooded and finished off and all doors and new locks on the doors. I put the locks on myself, all Yale locks. I redug the well. It was thirty-four feet and I dug it down to sixty feet, cased it and installed the pumping equipment.

Q. What kind of pumping equipment?

A. He had an automatic electric pump, push rod type pump.

Q. You know what it cost Tony to improve that well?

(Testimony of Albert Ruhl.)

A. I don't know the exact cost, but I dug the well. I imagine it must have cost for that thirty some odd feet I dug—must have cost him eight or ten dollars a foot.

Q. That is rather high, isn't it?

A. Not when you dug it by hand and the house was right there and the dirt had to be carried out in buckets.

Q. What kind of casing was used in the well?

A. Two by twelve casing.

Q. What else do you know about the construction of that building?

A. I know that he done more work on the basement, that he enlarged the basement a little. He built an outside entrance and also an inside entrance with steps, changed the windows around. [56] The whole place was almost rebuilt from its original—

Q. How much did you receive a day when you worked on the well?

A. I never worked for an actual wage for Tony. There was a deal—I was a cannery man. I came back from the hospital and was paid as a cannery man, but didn't have any job. In fact my house was occupied, and in order to be doing something I worked for Tony, but he did pay me something. I don't remember.

Q. Didn't you tell me he did pay you ten dollars a day for the well work?

A. I didn't say—that is about what he paid others.

(Testimony of Albert Ruhl.)

Q. Are you familiar with property values in South Naknek?

A. Yes.

Q. Based on your familiarity with other property in South Naknek, what was the value of Tony's building alone as of June, 1948, as of the time it burned?

A. I have a building of my own there that I value at five thousand dollars and it is not nearly as good, or as large a building as Tony's, and I believe his building to be worth ten thousand dollars at a minimum. I don't believe it could be replaced for that.

Q. You were in the building in July?

A. Until we went fishing, the 25th of June.

Q. What would you think it would cost to replace that building [57] in South Naknek?

A. I believe ten thousand dollars.

Q. Could you estimate the value of the equipment—stove—electric light plant, and the equipment he had? You operated it, did you not?

A. Yes. Not counting his provisions?

Q. Not counting provisions.

A. I think you could easily say worth two thousand dollars or twenty-five hundred.

Q. For equipment? A. Yes.

Q. Mr. Ruhl, approximately what date did you close that restaurant down?

A. I closed the restaurant down I think around the 23rd of June.

(Testimony of Albert Ruhl.)

Q. Was it operated to your knowledge after that date?

A. No, it wasn't. It was locked up and I had the keys. Tony didn't even have any keys.

Q. Do you know anything about this inventory?

A. Yes, there was between seventy-five and a hundred cases, including cases of canned milk. Bacon—ham.

Q. Can you look at this? By looking at that provisions list would your memory be refreshed so you could testify on any of the given items, Mr. Ruhl?

A. Yes. He had all these things, I believe, that is here. [58]

Q. Do you mean he had exactly every can that is listed there?

A. I don't know that. I never counted them up can by can, or case by case, but at different times I did more or less take a rough inventory of his food stuff downstairs. At the time he was feeding the men I more or less cooked for him. He was a little pressed for help. He was feeding twenty-five men and that came over night.

Q. During the time he fed these men he replenished his inventory from time to time, or did you know?

A. Yes, he was replacing all the time, in fact he bought to excess in lots of cases.

Q. You know how that happened, why he did it?

A. I think he was trying to build up his stock all the time and he had unlimited credit there. He was feeding twenty-five men a day at five dollars apiece, so his credit was very unlimited.

(Testimony of Albert Ruhl.)

Q. Did you and Tony go off fishing together?

A. Tony fished about two weeks before I did.

Q. You know why he closed the place down and went fishing himself?

A. Yes. At that time the canneries had opened up and the restaurant business wasn't too good. I operate a restaurant myself. It is easy for a man just to go to the cannery and eat and he don't have to pay for his meals and he also has a beer dispensing license and at that time I believe the season [59] was closed. For sixty days during the fishing season I believe the license is revoked so he couldn't sell beer either, and it paid him to close up and go fish.

Q. Will you look on the bottom of that bill of particulars, where it says chairs and six tables and so forth. Can you state whether or not all that equipment was in the building when you closed it down?

A. Yes, it was all there.

Q. It was all in the building?

A. Yes, sir.

Q. Look at the valuations on that page. Do you consider them nearly correct?

A. I believe he has it very low. I bought a bed over there this winter for myself, a double bed, for a hundred dollars. He has one listed here at eighty dollars. I wish I could have bought one like that.

Q. Did you have occasion to check this building after you closed it down from time to time?

A. Yes, I did.

Q. Was that on Tony's behalf?

A. I was looking after it for Tony and I came in on Saturday and on closed periods and I always

(Testimony of Albert Ruhl.)

made it a purpose to go to the restaurant and look it over. I think I came in the third time and it had burned down, the third or fourth time. I think I had been in three or four times. [60]

Q. Was the oil range shut off?

A. Yes, there was no oil in the stove. It had burned itself dry.

Q. When did that happen?

A. While I was still there. After I had closed down.

Q. Did anybody else live there? A. No.

Q. No one lived there after that?

A. Nobody.

Q. Did you see the building after it burned?

A. Yes, I did.

Q. You remember the date that it burned roughly?

A. I understood awhile ago the 20th, but I didn't believe it was that late, but I am not sure. The fishing season started the 25th of June and I think it was in the second week of fishing that the place burned, but that would put it around the 9th or 10th, somewhere around there.

Q. Well, when you examined the premises after you returned during the closed season what did you observe? A. What did I observe?

Q. What did you see when you went back to the place where the restaurant was?

A. When I went there I saw it had been—
The Court: You might as well ask if it was.

Q. Was anything left? [61]

(Testimony of Albert Ruhl.)

A. No. It was burned to the ground.

Q. Anything salvaged? A. No, nothing.

Q. There was a power house next to the building?

A. Yes.

Q. Was that burned? A. No, it was not.

Q. Was the privy burned?

A. No, it was not.

Q. You know what happened to that power house? A. No.

Q. How big was it?

A. A building about eight foot square, I believe.

Q. What type construction?

A. It was very well built, built for an engine house. It was Celotex and also plyboard with rustic sheathing on the outside.

Q. Look at the total of the provision list, Mr. Ruhl, and state whether or not that appears to be a fair estimate of the value of those provisions?

A. I would say it was a fair estimate.

Q. You have looked that list over before, haven't you? A. Yes, I saw that list before.

Mr. Nesbett: No other questions, Your Honor.

ALBERT RUHL

testifies as follows on

Cross-Examination

By Mr. Renfrew:

Q. Mr. Ruhl, there are a few questions I would like to clear up. You spoke of this little house

(Testimony of Albert Ruhl.)

eight by eight and described how it was constructed.

Was the light plant housed in that building?

A. No, it had never been in there.

Q. The light plant had never been in there?

A. No.

Q. Were you working for Polimeni on the 17th of April? A. Yes, sir.

Q. You know that the light plant was not there at that time? A. Yes, sir.

Q. Where was it at the time of the fire?

A. On the windbreak—back porch windbreak.

Q. Was it completely destroyed?

A. Yes, sir.

Q. What became of it?

A. Last I saw it was laying there in a bunch of tin and ashes.

Q. Were you in the immediate vicinity of the fire the day of the fire?

A. No, I was out on the fishing grounds in the boat. [63]

Q. What arrangements did you have with Mr. Polimeni to operate that place?

A. We hadn't really got to an agreement yet, although we had talked a time or two about going in together after the season, but it had never been settled.

Q. I understood your testimony to be that Mr. Polimeni left there sometime prior to the 23rd of June, when you closed it up? A. Yes.

Q. Prior to that when did he leave there?

A. I couldn't say exactly. I think the fishing

(Testimony of Albert Ruhl.)

season starts the 25th of June and I think he left about two weeks before that, so that would be the 10th or 15th of June.

Q. So you operated this place about ten days or two weeks when he wasn't there? A. Yes, sir.

Q. There has been some testimony here that a man by the name of Hansen was also with you?

A. It was Mrs. Hansen. She worked as a waitress for Tony during the time he was feeding the gang, but she wasn't there. At that time she was working at the Alaska Cannery.

Q. She wasn't working there during Mr. Polimeni's absence? A. No.

Q. You were the only one in it? [64]

A. Yes.

Q. What arrangement did you have for the two weeks?

A. We didn't have any arrangement.

Q. What happened to the money you took in?

A. I had about a hundred and fifty dollars of the money, and there was quite a bit of money there, quarters, half dollars and also checks, private checks people had written him that I had in a can. It didn't amount to very much. I don't know, might have amounted to a couple hundred dollars, but I wouldn't say for sure, because I don't know.

Q. Do I understand you, if somebody came in and wanted something you sold it and put the money in the can, and when you left you left the money?

A. No. I did take the money, but didn't take the silver.

Q. I didn't understand.

(Testimony of Albert Ruhl.)

A. I did take the paper money. I think it was about a hundred and fifty dollars, but I didn't take the silver or the private checks people had written.

Q. You had no understanding with Polimeni as to how you would run the place, or anything?

A. No, Tony trusted me, and I was more or less helping him get started.

Q. You glance over this inventory and state you have seen it before and you think that was about what he had there? A. Yes.

Q. And you also testified that during your acquaintance [65] with him from time to time he did augment this inventory by using up credit he had with the cannery people—he had there in town, isn't that right? A. Yes, sir.

Q. Do you know that they kept track of the goods that they sold him?

A. I don't know that. I do know that I figured up what he had coming for feeding these men one time, and it come to right close to four thousand dollars and that wasn't enough to cover his bill for supplies. I think he was still in debt about two thousand dollars.

Q. That would include all the provisions you used up? A. Not all used up.

Q. Did you ever see any of the invoices they sold him? A. Yes.

Q. Do you have any idea as to how this inventory that you say that you examined before was made up? A. This one here?

Q. Yes. A. No, sir, I don't.

(Testimony of Albert Ruhl.)

Q. Was it checked with the inventory, or so far as you know a guess? A. That I don't know.

Q. I understood you to mention something about hams and bacon, or did I misunderstand you? [66]

A. Yes, sir.

Q. Were there any? A. Yes.

Q. I don't mean in cans. Were there hams and bacon, raw meats? A. Yes, by the case.

Q. You know where they were purchased?

A. I believe they were purchased at Alaska Packers, although I wouldn't swear to that, I don't know.

Q. You are not positive? A. No.

Q. I notice on this inventory it says ham canned, fifty-nine cases. That is not what we were talking about? A. How is that?

Q. Here on this inventory it says ham canned, fifty-nine cases. That isn't the type of ham we are talking about is it? Canned ham?

A. No, he did have canned hams and I know that.

Q. That isn't what you referred to?

A. No. I think I did mention canned ham.

Q. It was ham and that wasn't canned?

A. Yes.

Q. How many hams there roughly hanging up in the basement, wasn't it?

A. Hanging up and some still in the cases. [67]

Q. I don't notice any of that on the inventory. Quite a bit of it, wasn't there?

A. Smoked ham?

Q. Yes.

(Testimony of Albert Ruhl.)

A. Quite a bit.

Q. Were you a watchman for the cannery that winter?

A. I had been that winter, but had been out. Had broken my arm.

Q. You had charge of the cannery in March?

A. Alaska Packers.

Q. Who was it? You know? A. Yes.

Q. What is his name? A. Stanley Roher.

Q. Do you know whether or not he is in the country? A. No, he is not in the country now.

Q. You went into some detail, Mr. Ruhl, about the well. Was the well burned?

A. No, I don't think the well was burned. It was in the basement. It was cased over on top, but it wasn't usable I don't believe.

Q. Did you ever look in the well afterwards?

A. Yes.

Q. Was the casing alright?

A. The top part was burned off. [68]

Q. Just the top, but the sixty feet in the well was alright? A. Yes.

Q. Do I understand that the work you did in the building was sometime between the 4th and 5th of February, 1948, and until it was opened in March?

A. Yes, sir.

Q. And did you have any kind of arrangement with Mr. Polimeni for your services at that time, or was that the same deal you had when you ran it for the ten days or two weeks when he wasn't there?

A. No, I didn't have any special agreement there.

(Testimony of Albert Ruhl.)

At different times I offered to do the work to help Tony get started, but different times he gave me fifty dollars and I ate and slept there.

Q. You mentioned you have a restaurant now. You didn't have it at that time I take it?

A. I bought it in August, 1948, after fishing season.

Q. Do you have any idea how this fire started?

A. No, sir. I do not.

Q. Do you know what portion it started in?

A. No, sir. I heard it was in the front and in the back. I don't know.

Q. Do you know of anyone that was there or could say whether or not there was any attempt made to extinguish it?

A. Yes, there was several people there. [69]

Q. They are there now?

A. Yes, Womper, Jones, Hansen. Yes, there was a man—no, he is not there now. This school teacher.

Q. Is that school teacher there now?

A. Yes.

Q. Do you know anything about the letters Mr. Polimeni had written in connection with an application for an insurance policy?

A. I know some about them. I was the one that measured up the place, how far from the school and how far from the postoffice.

Q. You know who wrote the letters?

A. A school teacher wrote them. I helped her to word them.

(Testimony of Albert Ruhl.)

Q. You know Bill Smith? A. Yes, sir.

Q. You heard his testimony this morning?

A. Yes.

Q. You also helped to write them?

A. I helped to word them.

Q. The school teacher did the actual penmanship? A. Yes.

Q. And Smith worked them over?

A. I don't know.

Q. You heard him testify?

A. I thought he testified he gave some advice about it. [70]

Q. Did anyone else have anything to do with the writing of these letters?

A. Not to my knowledge.

Q. Were you there when the letter counselor referred to as the June 4th letter to Tony, stating they hadn't received any information and had no information, was received?

A. I believe I remember it.

Q. Did you discuss that with Mr. Polimeni?

A. I believe I did.

Q. What did you recommend to him at that time, if anything?

A. I don't remember at that time what I did recommend to him.

Q. Do you remember that shortly after the 4th of June that he did receive a letter stating they did not have the information so that they could place the insurance, and until they got that information they couldn't place it?

(Testimony of Albert Ruhl.)

A. It seems to me there was something about writing him and finding out what information they wanted. I don't know.

Q. Did you after the receipt of that letter do anything like you did previously? That is go to the school teacher and ask her to pen a letter in reply?

A. I don't believe I did at that time.

Q. How did it happen, Mr. Ruhl, that a school teacher was asked to write the letter? They were done not on a typewriter, but in longhand?

A. Yes. At that time I was not able to write very good. I [71] had had my arm broken and she is a good penman.

Q. Was it your right arm? A. Yes.

Q. How did you dig that well?

A. It doesn't bother me to work with it.

Q. It doesn't bother you to dig, but you couldn't write?

A. I can dig, but it isn't easy for me even today to write.

Mr. Renfrew: That is all.

Redirect Examination

By Mr. Nesbett:

Q. May I have just a moment or so?

The Court: Yes.

Q. Showing the witness Exhibit No. 4 of defendant's answer. Do you recall that letter, Mr. Ruhl?

(Testimony of Albert Ruhl.)

A. I don't remember this letter. No, I don't believe I had anything to do with that.

Q. Showing you Exhibit 5.

Mr. Renfrew: Just a moment. So that I can identify these for the purpose of cross-examination when you refer to Exhibit 4 that is the letter of June 1, 1948?

Mr. Nesbett: Exhibit 4 of defendant's answer.

Mr. Renfrew: All I have is a copy.

Mr. Nesbett: It is your answer. It is Exhibit 4 and the letter of June 4th. [72]

Mr. Renfrew: Four is his answer. It was June 1st.

Q. Now, referring to Exhibit 5. Did you see that letter?

A. Yes sir. I have seen this letter.

Q. When you got the letter did you discuss it with Tony?

A. Yes, that is the time I measured how far from the school house, how far from the postoffice and its location there.

Mr. Renfrew: Did I understand his answer to be that was the time that he made the measurements.

Q. Yes and you refer now to the June 4th letter. Yes. Now look at Exhibit 3 and state whether or not you were not confused in your last answer?

A. Yes sir. I helped take up this letter too with the school teacher.

Q. That was done sometime before April 17th?

A. Yes sir.

(Testimony of Albert Ruhl.)

Q. You made those measurements?

A. Yes sir.

Q. Did you go out and measure some more after you received this letter of June 4th, which is Exhibit 5, where it says apparently you didn't receive my letter of April 9th?

A. How was that question again?

Q. I say when you received the letter of June 4th did you go out and take any other measurements?

A. That was the only time there was any measurements made, [73] I believe.

Q. What did you do when you received that letter of June 4th?

A. I went out and measured the building and got the distance between the building and the school house. I think Tony went to the school teacher and——

Mr. Renfrew: Object as hearsay.

Q. If you know?

A. I don't know. I gave him the distances.

Q. Have you ever seen this letter of July 23rd?

A. Yes. I seen that.

Q. Did it arrive in the mail on or about July 23rd?

A. I forget the exact date, but I believe it was after the place burned down.

Q. That you received the letter.

A. That I saw the letter, because Tony was gone.

Q. Did you open his mail?

(Testimony of Albert Ruhl.)

A. No sir. I did not.

Mr. Nesbett: That is all.

Recross-Examination

By Mr. Renfrew:

Q. Again the letter of June 4th. It starts out "We are in receipt of your letter of June 1st." Do you have that before you now?

A. Yes sir. [74]

Q. Now, did I understand you to testify that you had seen that letter and that after you saw it you went out and made some further measurements and told Tony about them? Is that correct?

A. I am not sure about that. I know I went out, but I am not sure this is the letter. After I found out they had to have measurements I went out and measured it.

Q. Mr. Nesbett pointed out to you that you obviously did that prior to the letter of April 17th. Then I asked you when you got this letter, or did you?

A. I believe I did it after I got this letter, because I don't believe—I don't know.

Q. Go back two pages and look at the letter of April 17th. That would be Exhibit 3. It starts out, "Having received your reply to my inquiry concerning my insurance." You have that letter before you?

A. Yes.

Q. Now, did somebody furnish a lot of dimensions and distances?

(Testimony of Albert Ruhl.)

A. Evidently there must be a letter notifying us they had to have that before this time.

Q. Evidently that is correct. Now, you furnished the information about which that letter was written on April 17th? A. Yes.

Q. Now, I ask you to go back to the letter of June 4th and ask [75] what you did after that?

A. I don't think I did anything about it. I think I was mistaken about this letter.

Q. You remember ever seeing that letter of June 4th?

A. Yes, I have seen that letter before.

Q. Alright. Now you are positive of that, because that letter states in effect that they hadn't received the information contained in the letter of April 17th, doesn't it? A. Yes.

Q. What did you do when you got that letter stating that they had not received the information which you sent them under date of April 17th?

A. I didn't do anything, didn't do anything about it.

Q. Were you in the capacity at that time of advising Mr. Polimeni as you were on April 17th, when you took him to the school teacher?

A. I think he must have had the information already and I didn't go out and measure it again.

Q. Is it your information that you got the letter of June 4th but couldn't recall that you gave him any advice at all? A. I don't know that I did.

Q. I will ask you if Tony can read that letter? Can he read the English language?

(Testimony of Albert Ruhl.)

A. I think he can.

Q. As long as you were around he got mail from other people? [76] A. Yes.

Q. Did he read it himself?

A. He read it himself, but sometimes he cannot.

Q. You remember having any conversation with him about the letter of June 4th, about coaching him as to the distances and so forth?

A. I remember reading the letter there alright, but I don't remember doing anything about it.

Q. You don't remember discussing it with Mr. Polimeni at all?

A. Yes. We discussed it, but I don't remember what was said at that time.

Mr. Renfrew: I guess that is all.

Further Redirect Examination

By Mr. Nesbett:

Q. Mr. Ruhl, look at the letter of April 9th and see if you are not confusing it with the letter of June 4th. The letter of June 4th quotes the letter of June 9th?

A. Well, I believe that I could be. It sort of had me confused awhile ago. I believe that might be the letter I referred to.

Q. After the letter of April 9th you went out and made measurements? A. Yes. [77]

Q. Then look at the letter of April 17th.

A. Yes.

(Testimony of Albert Ruhl.)

Q. That is the letter containing the measurements? A. Yes.

Q. You made those measurements yourself?

A. Yes.

Q. Now look at the letter of June 4th. That is identical with the letter of April 9th, except the first paragraph. You want to add anything to your testimony?

A. I believe I am mistaken. I believe I was confused with the letter of April 9th.

Q. Then is it your testimony that you never saw the letter of June 4th?

A. I believe not. I believe I have that confused with the letter of April 9th.

Further Recross-Examination

By Mr. Renfrew:

Q. Did you not testify a few moments ago that you were aware of the advice to Mr. Polimeni which in effect told him we have not received the information we requested and you will have to furnish us this information before we can give you any insurance?

A. I don't recall of ever talking to him about anything like that. [78]

Q. You don't remember?

A. That is right. I can't remember talking it over with him about this letter.

Q. At that time weren't you contemplating a partnership with Tony?

(Testimony of Albert Ruhl.)

A. Yes, we had talked it over more or less, having a working arrangement with him after the season——

Q. You were pretty interested in the insurance?

A. I would only have a working interest in it.

Q. Yes, but you were urging him to buy the insurance.

A. I was interested in it and trying to help him.

Q. That is right. Now look at Exhibit 4, the letter of June 1st. Didn't you tell him that you better write and see why you don't get the insurance?

A. Yes, but I don't know whether he did go to the school teacher or not.

Q. You remember the incident and saying he better write in and see why he didn't get any insurance? A. We talked about it.

Q. You did talk about that?

A. We talked about why he didn't have the insurance.

Q. Did you ask him why he didn't get it?

A. No.

Mr. Renfrew: That is all.

Mr. Nesbett: May I ask one more question? [79]

Further Redirect Examination

By Mr. Nesbett:

Q. Look at the letter of June 1st. What does that say?

A. I have written you before concerning insur-

(Testimony of Albert Ruhl.)

ance for my restaurant and received no reply. I didn't have anything to do with this letter either.

Q. Wasn't that the letter you were just testifying about?

A. I don't remember whether I told him to write or not.

Q. You don't remember whether it was the letter of June 1st or June 9th, or whether it was just a discussion you had about it? A. No sir.

Mr. Nesbett: No further questions. Call Mr. Coffey.

The Court: Unless he is a short witness.

Mr. Nesbett: In so far as we are concerned he will be. I have about three questions.

EDWARD D. COFFEY

being called as a witness on behalf of the plaintiff, and being first duly sworn, testifies as follows on

Direct Examination

By Mr. Nesbett:

Q. Your name is Edward D. Coffey?

A. Yes. [80]

Q. You are an insurance agent and broker in Anchorage? A. Yes.

Q. You were so engaged in March, April, May, June and July of 1948, were you not? A. Yes.

Q. State what companies you represent and in what capacity?

Mr. Renfrew: This is incompetent, irrelevant and immaterial.

(Testimony of Edward D. Coffey.)

The Court: I don't see the materiality of it. How do you claim it is material.

Mr. Nesbett: I just want to know that he does represent some as agents and some as brokers. Some question of authority of a broker or agent may come up and I would like to have that information.

Mr. Renfrew: He has just testified he is an agent and a broker.

The Court: I think the objection is well taken in view of the fact no insurance company was involved. It would be immaterial what companies he writes insurance with.

Mr. Nesbett: Since we have (Inaudible) on a tort contract.

The Court: You say you have what?

Mr. Nesbett: You say Your Honor takes that view?

The Court: You said something before that.

Mr. Nesbett: On one cause of action we are [81] suing on breach of contract. The question I thought might arise was whether or not Mr. Coffey could have written a policy based on the information received in the letter of April 17th. As an agent it is our theory he could have, as a broker I don't know. So far as tort is concerned it makes no difference.

Mr. Renfrew: Your Honor, what difference does it make the names of the companies he represents? Counsel is going far afield. He could ask could you

(Testimony of Edward D. Coffey.)

have written this insurance, or did you, but not the name of the company.

The Court: I don't see how it would be relevant—the name of the company.

Mr. Nesbett: Could I ask this question, "How many companies does he represent as agents and brokers?"

The Court: As an insurance man it is permitted——

Mr. Renfrew: Your Honor, whether it is three or thirty three how is it material whether this man is an insurance agent for thirty five years or thirty five days. He is sued on two counts. It don't make a particle of difference——

The Court: As a matter of fact, his experience, or his testimony could always be applied in the light of his experience, but when you mention tort. That don't seem to me to be the case here. This is set up in two ways, one by non-performance, or breach, and the other by negligence.

Mr. Renfrew: The negligence, Your Honor, [82] is counsel's theory of the tort.

The Court: But the negligence would not exist without the contract.

Mr. Renfrew: That is what the cases held, but not their theory.

Mr. Nesbett: I have my theory of it too and cases that might be favorable to me.

The Court: I think the Court would be interested in hearing your theory, because the theory I get

(Testimony of Edward D. Coffey.)

from the pleadings is that both are predicated on an equitable contract, but I don't see how there could be any negligence predicated on anything except the theory of a contract.

Mr. Nesbett: Your Honor, if you don't consider it material whether or not he had authority to issue a policy based on the letter of April 17th I won't go into it any farther.

The Court: I don't think I held anything of the kind.

Mr. Nesbett: I couldn't find out which companies he had the right to issue a policy for and which he did not.

Mr. Renfrew: How could you find out whether he had authority to issue a policy?

The Court: I don't see where proof of that kind would serve any purpose here. If he had authority to issue [83] the policy it wouldn't make any difference through which company he could have issued the policy.

Mr. Nesbett: Could I ask how many he represented as agent and how many as brokers?

The Court: You may.

A. As a matter of fact I couldn't tell you off hand without checking to see. I represent one company as general agent.

Q. One company as general agent?

A. Yes.

Q. As a broker you know roughly how many you represent, Mr. Coffey?

A. I will qualify my answer after I gave the

(Testimony of Edward D. Coffey.)

answer. We probably represent in the office, I would say, fifteen companies, and qualifying that we represent them with certain restrictions as to certain risks that they assume, or that they would care for us to write and on which we have specific instructions from them.

Q. You represent those fifteen companies as brokers? A. As agents.

Q. And you represent any solely as brokers?

The Court: I think that may be confusing. If he is a broker he does not represent them.

Mr. Nesbett: If he represents them——

The Court: Then he would be their agent. He could just deal with them as a broker. [84]

Mr. Nesbett: Maybe he does that.

The Court: Representing a company, it seems to me, implies agency.

Mr. Renfrew: I think what counsel is trying to get at is whether or not he has binding authority.

Mr. Nesbett: I mean as a broker.

A. Placing it.

Mr. Nesbett: Placing it with a company, any one of several companies.

The Court: You may go ahead and ask.

Q. How many do you represent as broker?

A. I call to mind just one.

Q. One more question.

A. Pardon me. I will qualify that, if I may. A broker and an agent is a fine distinction so far as their brokering business and consummation—I mean brokering business, and for the final consum-

(Testimony of Edward D. Coffey.)

mation the ordinary broker would not have a license to represent any company. The agent would under certain restrictions.

Q. One more question.

The Court: You said only three questions and it is five o'clock now.

Q. This one.

The Court: One more and that is all.

Q. Were you in Anchorage between March 30th, 1948, and July [85] 23rd?

A. I believe I have a letter in my correspondence where I probably returned to Anchorage in the middle of April and again I went out and I don't know when I returned. Yes, I was here about a week and went out again. I will furnish that tomorrow, if I can.

The Court: Ladies and Gentlemen, we are about to adjourn. You will bear in mind the admonition I have previously given you and be in Court tomorrow morning at 10 o'clock.

(Whereupon Court adjourns until 10 o'clock a.m., April 18, 1950.) [86]

April 18, 1950, 10 o'clock a.m. [87]

The Court: Is counsel through with examining the defendant? Do you wish to cross-examine?

Mr. Renfrew: I understood there was an unanswered question about the time question that Mr. Coffey said he would answer this morning.

(Testimony of Edward D. Coffey.)

The Court: Then the defendant may resume the stand.

EDWARD D. COFFEY

being called as a witness on behalf of the plaintiff resumes the stand and testifies as follows on further

Direct Examination

By Mr. Nesbett:

Q. Mr. Coffey, is it possible now for you to answer the question to this effect were you in Anchorage between March 30th and July 23rd, 1948?

A. My bookkeeper has been ill and I haven't had time to get full information on that. I can give you partial information, however. I have a statement from the New Washington Hotel that I paid on 4-5-48. I would say I was here about a week and then I again went to Seattle. However, I found another statement of 4-9-48. I don't know whether I went to Portland or—I couldn't have been in Anchorage on the 19th though, I am sure of that. My memory is not too clear, however. I was out of town sometime in June and I am sure I was outside at that time. When I returned it may have been around July, I [88] couldn't give the exact dates due to the illness of my bookkeeper.

Mr. Nesbett: Thank you.

A. If you don't mind me qualifying what I said last night. You asked if an agent that has an agent's license can broker business, which we do, but an agent holding a license can write business

(Testimony of Edward D. Coffey.)

within the City of Anchorage, or a town that has fire protection, but my companies prohibit me from writing unprotected risks out of town. I must submit that to them with full information as to underwriting in order that they might consider the hazardous risks, as they deem many risks undesirable and do not accept them, such as out of town risks, airplane hangars, bowling alleys, gambling, restaurants, liquor and boarding houses. They want us to submit these. They want to consider all the facts on out of town business.

Q. Is that your testimony, Mr. Coffey, that you could not have written the insurance without getting information?

A. It is not our custom to write out of town business of any kind—on anything like that—

Q. Answer the question. Will you answer the question? A. Yes.

Q. Is it your testimony that you could not write a policy on Mr. Polimeni's property without first checking with the parent company and getting permission? A. Yes, that is right. [89]

Q. Is it your testimony that you could not have written a policy based on Mr. Polimeni's letter of April 17th without checking with your parent company?

A. That is right. We would have submitted.

Q. Isn't an agent authorized to bind the companies he represents up to a certain limit on unprotected property?

A. It is not our understanding to bind—

(Testimony of Edward D. Coffey.)

Q. Isn't it possible?

A. It is possible if we violate our companies agreement. In our agreements——

Q. What is meant by the term issue on an insurance policy? A. To write a policy, I suppose.

Q. You insure everything, don't you?

A. No, we don't. We submit it.

Q. You advertise all over, don't you, Coffey insures everything, remember?

A. We submit it.

Q. Don't you have as much power as any agent in the Territory of Alaska in writing insurance?

A. I think we do on protected stuff.

Q. Wouldn't it have been possible from Mr. Polimeni's letter of April 17th to have bound four or five of the companies you represent as agent to a limited extent to cover Mr. Polimeni for a total of ten thousand dollars? A. No sir. [90]

Q. Is it your testimony that you never do that?

A. No, we don't do it until it is submitted to the company if it falls in these categories.

Q. You mean a restaurant?

A. Yes. That is right.

Q. Would it have been possible for you to have bound four, five or six of your people on it without submitting to the parent company first?

A. That is right.

Q. Is it your testimony you could not have done that covering certain property in South Naknek for so many dollars?

(Testimony of Edward D. Coffey.)

A. They don't want to accept unprotected risks without full information.

Q. You have never done that? A. No.

Q. Is it possible to have done that?

A. I beg your pardon.

Q. Could you have done it?

A. We don't do it not on unprotected risks.

Q. Then you have never in the conduct of your business done anything like that?

A. We may have a few years ago, but in the last few years several companies have withdrawn from the territory due to unfavorable experience on out of town and prohibited risks.

Q. Is it your testimony that you never did anything like that [91] during the year 1948?

A. You are asking me a question that I don't—

Q. If you don't want to say.

A. I don't know. I will put it that way.

Mr. Nesbett: Your Honor, I subpoenaed Mr. Joseph Sheahan for 10 o'clock. I don't see him.

The Court: Did you have the subpoena issued in time?

Mr. Nesbett: Yes.

The Court: Has the subpoena been served?

Mr. Nesbett: Yes.

The Court: What is the name?

Mr. Nesbett: Mr. Joseph Sheahan.

The Court: Will you look in the Marshal's Office to see if he may be there.

Q. Mr. Coffey, you represent one company as general agent, I believe you said. A. Yes.

(Testimony of Edward D. Coffey.)

Q. Which company is that?

Mr. Renfrew: Object as immaterial.

The Court: In view of the testimony——

Mr. Renfrew: It is his witness.

The Court: I know, but he is the adverse party and the examination may be conducted as a cross-examination.

Mr. Nesbett: I have no wish to drag one company's [92] name out more than any other. He may designate it as "Company A."

The Court: That will be the ruling.

Q. What are your powers then with this company as general agent?

A. We are general agents for the accident and health business only.

Q. How many companies do you represent as agent for the writing of fire insurance?

A. I would say roughly nine.

Q. Roughly nine companies? A. Yes.

Q. Could you state, Mr. Coffey, without checking your records the limitations you had with relation to binding each of these nine companies on a risk?

A. In town they have block limits.

Q. Block limits?

A. They have block limits. In Anchorage one company may say we will permit you to write not more than five thousand dollars on a risk in the incorporated town of Anchorage, and not more than fifty thousand dollars in the block. That makes in a full block we will say bounded by Fourth and Fifth and by E and D.

(Testimony of Edward D. Coffey.)

Q. Alright, now what powers do you have with these nine companies outside incorporated areas?

A. We have two companies only that we could write on a residence fifteen hundred dollars each on residences unprotected. That is out of town. The other we have to submit for their advice if they would like to accept the business.

Q. That can be submitted either by wire or by letter, can it not? A. That is right.

Q. And upon confirmation by the parent company the risk is in force? A. That is right.

Q. As a matter of fact, it is customary among agents to state that you are now insured before you have ever checked with the company?

Mr. Renfrew: That is calling for a conclusion.

Mr. Nesbett: If it is the custom it certainly wouldn't be.

The Court: You mean the particular custom, or the general custom?

Mr. Nesbett: The general custom.

The Court: The next question is whether evidence of a general custom of this kind might be inconsistent with the terms of the policy, because if it is it cannot be admitted because of the terms of the policy.

Mr. Nesbett: I have done a little research and it seems to me that he is bound and the company is bound by [94] the general custom.

The Court: But the point I make is entirely different, that if the custom would tend to contra-

(Testimony of Edward D. Coffey.)

dict any of the written provisions of the policy or its terms it wouldn't be admissible.

Mr. Nesbett: You mean the agency agreement, Your Honor, rather than the policy.

The Court: No, the policy.

Mr. Nesbett: But I haven't brought anything in about the policy.

The Court: You are building up the general customs of insurance agents.

Q. Could an agent say Mr. Jones I have checked your property over and you are insured for seven thousand dollars and when the confirmation came through it would be insured nunc pro tunc to the time he said Mr. Jones you are insured?

Mr. Renfrew: Your Honor, that question is completely hypothetical. It is irrelevant in this case up to this point, because what difference would it make if the agent would say that, if he didn't bind the insurance it wouldn't bind the company, and there is no testimony that Mr. Coffey, or anyone in his office, said this, and if it were a custom—even if it were—it isn't revelant.

The Court: If it is a general custom he would be presumed to know of it and be bound by it seems to me that [95] the question——

Mr. Renfrew: How is it material, Your Honor, in the instant case?

Mr. Nesbett: Your Honor, as I see it it is material in this respect we have also charged Mr. Coffey with negligence. After undertaking to procure insurance he failed to go through with the

(Testimony of Edward D. Coffey.)

plan and it is relevant that we know whether or not it was possible for him to insure Polimeni upon the receipt of this information that Polimeni forwarded to him.

Mr. Renfrew: I submit the witness answered that and said it was impossible for him to do that.

Mr. Nesbett: Under his agency agreement it might be, Your Honor, but as I see it he is bound by what power the public thinks he has.

Mr. Renfrew: I will eat any law books that substantiate that, Your Honor.

Mr. Nesbett: I will dig up some.

The Court: The only way it would be relevant is on the question of the ostensible authority of the agent. In other words if it is a general custom of insurance agents to do that it would certainly be presumed that the insurance carriers themselves would know of it and if they did nothing about it it would be within the scope of the agent's authority. Maybe you better ask the question again.

Q. Isn't it the general custom, Mr. Coffey, among agents [96] after learning the details of the application to state alright you are insured, and then confirm with their company by telegram, or by letter, and after getting the confirmation have the insurance become effective as of the time they first said it was insured.

A. If we wired the company they come back and say this is binding. I will try to answer it this way for you, if you meet a man on the——

Q. Just answer the question.

(Testimony of Edward D. Coffey.)

Mr. Renfrew: Let him answer.

A. I am trying to help you. If I met a man on the street and he said, "Ed, I would like you to insure my house," I say where is it located. We are talking about Anchorage, because we do have binding authority to a certain extent on protected property. I would try to find out whether it was next to a gambling house, family boarding house, or something of this category, and knowing the man and the moral risks connected with it—whether he has had any losses and knowing the man I would ask him how much he wanted on it. He would say five thousand dollars and I would say how much you want on the house and how much on the furniture. If that was in the City of Anchorage, and we were not violating our authority, I would go in the office and write up a binder. We would retain one and send one out, but in order to protect ourselves with the company we would drop the binder in the mail and that would [97] suffice for them to issue the policy that particular day. Out of town risks we would not bind on any prohibited risks.

Q. On that particular situation you have recited, the company is bound as of the time you drop it in the mail?

A. That is the only time they will bind according to our interpretation.

Q. Suppose it was a residence outside the incorporated area and you agreed to insure for a certain sum of money and you wired your company for

(Testimony of Edward D. Coffey.)

confirmation, isn't it common custom to consider the insurance going into effect as of the time you told the man after the confirmation comes through?

A. Only the amount we are qualified to write for. There are only the two companies that we have authority from to write fifteen hundred dollars on a risk.

Q. Then if you covered five or ten thousand dollars the insurance would be considered as having gone through as of the time you told him?

A. We have authority from only two companies on out of town risks.

Q. Assuming you sent in the wire to get authority. In other words take this situation. You have all the details on Polimeni's restaurant, one thousand feet from the school building, three hundred feet from the postoffice and so forth, and you wire for authority, in other words confirmation on that risk, isn't it generally considered that Polimeni would be covered [98] at the time you send in the application, although the confirmation comes through later?

A. No, there is no binding there until the company says there is binding. There couldn't be.

Q. After the company says we will accept that risk isn't it generally considered as insured as of the time you accepted the application?

A. So far as we are concerned it is binding from the time the company says it is binding.

Q. Is your answer then no?

A. It would have to be.

(Testimony of Edward D. Coffey.)

Q. You are positive of that? A. Yes.

Q. Will you answer this, Mr. Coffey? After receiving Mr. Polimeni's letter of April 17th—you read it I guess?

A. I am not too familiar with it. I would like the copy again if you want to refer to it. It was taken care of in my office while I was away and not by me.

Q. It is marked Defendant's Exhibit 3 in defendant's answer.

A. If you don't mind I want to familiarize myself. Previous to that exhibit.

Mr. Renfrew: May we have a short recess, Your Honor. It is going to take Mr. Coffey at least ten or fifteen minutes to read that correspondence.

Mr. Nesbett: Your Honor, it needn't take that long. He wrote it.

Mr. Renfrew: He says he didn't write it. Counsel knows that.

The Court: I think that the time spent in recessing and re-assembling here would suffice for him to go through that, and since it is only half hour since we started out we should continue.

Q. Will you look at that letter? A. Yes.

Q. Wouldn't it have been possible after receiving that letter to immediately dispatch a wire to your company, asking for confirmation on the property, saying something to this effect details to follow, or could you have sent off a wire?

Mr. Renfrew: You mean physically or within the scope of his authority?

(Testimony of Edward D. Coffey.)

The Court: I think, of course, he is referring to whether or not his authority would permit him to do so.

Q. Well, I don't think you are looking at the letter now.

Mr. Renfrew: It is obvious, Your Honor, that this question cannot be answered until the person familiarized themselves with the preceding letter and the following letter. Unless Mr. Nesbett gives Mr. Coffey a chance to do that.

A. If the office would feel that this was sufficient information and knowing the background as to previous loss experience then they would ordinarily transmit an airmail letter for [100] the submitting of this business. Does that answer your question?

Q. For the submitting of it?

A. For the company's consideration.

Q. In other words, your office on receipt of that application and information would send an airmail request to the parent company?

A. If we felt the information was sufficient—what they wanted.

Q. It would have been within your power to have done so? I mean it would have been customary to have done it?

A. If we felt there was sufficient information in the letter it would probably have been a routine matter of transacting business.

Q. Then on receipt of this letter the parent company would have considered the application?

(Testimony of Edward D. Coffey.)

A. Yes, they would have either said they would have accepted it or not.

Q. If you had telegraphed?

A. We hesitate to send telegrams, because the customer doesn't like to have to pay for it.

Q. If you had telegraphed them they would also?

A. If we had requested them to telegraph they would have. Yes.

Mr. Nesbett: I believe that is all, Your Honor.

Mr. Renfrew: No questions.

Mr. Nesbett: Mr. Joseph Sheahan is here now, Your Honor. I want to call him.

JOSEPH SHEAHAN

being called as a witness on behalf of the plaintiff and being first duly sworn, testifies as follows on

Direct Examination

By Mr. Nesbett:

Q. Your name is Joseph Sheahan, is it not?

A. Yes. Joseph Sheahan.

Q. S-h-e-a-h-a-n? A. That is right.

Q. You are engaged in the insurance business in Anchorage, are you not? A. I am, Yes.

Q. What is the name of your company, Mr. Sheahan? A. Joseph W. Sheahan Agency.

Q. How long have you been engaged in the insurance business altogether, Mr. Sheahan?

A. That is disclosing my age, but it has been about thirty-two years.

(Testimony of Joseph Sheahan.)

Q. How long have you been engaged in the insurance business in Alaska?

A. I think five and a half to six years. [102]

Q. I will ask you whether or not you have ever worked for Mr. Ed Coffey of the Coffey insurance company?

A. Yes, I have.

Q. How long did you work with Mr. Coffey, Mr. Sheahan?

A. About a year and two months, I believe.

Q. You know approximately the date you terminated your association with Mr. Coffey?

A. January 22nd, 1948.

Q. Mr. Sheahan, I have talked with you about this case, haven't I?

A. Yes.

Q. I showed you some correspondence involved in this case, did I not?

A. Yes, but I don't recall it.

Q. How many companies do you represent as agent?

A. Seven.

Q. You represent any as general agent?

A. No, none.

Q. Seven companies just as agents?

A. Local agents. We call them, of course, agents. Yes.

Q. Mr. Sheahan, do you have any authority as agent of your companies to bind risks?

A. Of the companies that I——

Mr. Renfrew: Just a moment. We object to any further testimony on this line. It is incompetent, irrelevant [103] and immaterial. What Mr. Shea-

(Testimony of Joseph Sheahan.)

han's custom in his business might be is not binding in any matter whatsoever on Mr. Coffey. If they represented the same companies, but there is no showing, and if they represented different companies——

Mr. Nesbett: I would like to show which companies they represent, maybe they do represent the same companies.

The Court: No, I don't——

Mr. Nesbett: I still think the question is proper, Your Honor, to get the relative authority of the two agents.

The Court: Don't you have to show first that the practice of insurers is the same?

Q. I will ask you what is the practice of parent companies with respect to delegating powers to their agents.

Mr. Renfrew: Same objection. It is absolutely immaterial. There is no possible way it could be material. I can't see any theory on which such an answer could have any issue in the case at bar.

Mr. Nesbett: I expect to tie this in to support my case against Mr. Coffey on negligence, and I assure Your Honor I have a definite plan.

The Court: Overruled. Proceed.

A. Insurance companies—I am embarrassed, frankly, because I have the highest regard for Ed.

Q. Mr. Sheahan, you are not here of your own free will and accord? A. No, I am not.

Q. I subpoenaed you as a witness and gave you a days pay?

(Testimony of Joseph Sheahan.)

A. That is right. Insurance companies invariably give you what they call a prohibited list. It is called a K-O list. It means keep off. There will be certain risks but they do give you authority to bind. By binding I mean to cover certain risks. Inside of town, where it is protected, your authority is far greater than it is in outside unprotected areas. I think that usually the authority outside is to twenty-five hundred dollars a company.

Q. The authority, Mr. Sheahan, to bind the company without——

Mr. Renfrew: I move that the answer be stricken from the record and the jury instructed to disregard it on the ground it has no bearing on anything with which Mr. Coffey, who is the defendant in this case, is concerned, and even if Mr. Sheahan has a company to bind up to twenty-five hundred dollars it would have no bearing whatsoever on Mr. Coffey.

The Court: That would be true if it were the extent of the examination, but I am going to let it go. Objection overruled.

Q. Is it your testimony that the general authority of the agent to bind the company he represents on outside risks is twenty-five hundred dollars? [105]

A. Some are more liberal than others. Some will go fifteen hundred or two thousand dollars and others will tell you to use your good judgment and go to ten thousand.

Q. Mr. Sheahan, if you had received correspondence as Mr. Coffey did, commencing with Exhibit 1

(Testimony of Joseph Sheahan.)

of defendant's answer through Exhibit 5, will you state to the Court what procedure you would have followed?

Mr. Renfrew: Objected to as calling for an opinion of this witness, is not binding upon the defendant and surely he can't answer what he would have done not knowing the companies Mr. Coffey represents.

The Court: I think the objection should be sustained. I think all he can do is answer what could have been done according to general custom.

Q. Mr. Sheahan, if you had received an application for insurance from Naknek on March 30th and——

Mr. Renfrew: Just a moment. We object to counsel's statement of an assumption of an application. There is nothing in the record to indicate there was any application made on the 30th day of March.

The Court: You mean a formal application?

Mr. Renfrew: Any kind of application at all. There is not a thing before the jury or before the Court.

Mr. Nesbett: That is Exhibit 1.

Mr. Renfrew: There is no exhibit before the Court. [106]

Mr. Nesbett: It is a part of the pleadings.

Mr. Renfrew: It is not an exhibit and not an application.

Mr. Nesbett: You labeled it as an exhibit and attached it to your answer.

(Testimony of Joseph Sheahan.)

Mr. Renfrew: It is not in evidence, Your Honor.

The Court: No, it is not in evidence and I think before it could possibly go before the jury it would have to be introduced. Yes, I think it would have to be introduced, otherwise it wouldn't go before the jury.

Mr. Nesbett: I will withdraw the question then. Is it your ruling, Your Honor, that I cannot show it to the witness, that I cannot show to the witness any of the exhibits attached to the defendant's answer?

The Court: I think you ought to have it marked for identification first.

Mr. Nesbett: I will request that five, or seven, no all nine, Your Honor.

The Court: The reason I rule that way I do not submit pleadings to the jury. If I did they would go in that way as part of the pleading.

Mr. Renfrew: Your Honor, I have never heard of a practice such as this. He takes a pleading out of the file, or his copy, and he asks that it be marked for identification. What is it? [107]

Mr. Nesbett: Defendant's Exhibits 1 to 9 attached by Mr. Renfrew's office to the answer.

Mr. Renfrew: I haven't any exhibits before this jury at all, and if he has anything there it is merely a copy of a pleading and that is all he has.

The Court: But the Court has ruled that he should introduce these exhibits into evidence, or for identification, in order that they may be marked. It is obvious they cannot be marked otherwise.

(Testimony of Joseph Sheahan.)

Mr. Renfrew: I think that is correct, Your Honor, but I thought he was going to have them marked and handed to Mr. Sheahan.

The Court: It merely involves the order of proof and in order to save time you could take this witness off the stand and put somebody else on to make the offer of the exhibits. However, I will permit the order of proof to go on this way.

Mr. Nesbett: Your Honor, Mr. Coffey swore to that answer.

The Court: That may be, but since they haven't been offered in evidence I thought you would perhaps want to resort to this method. However, if you want to——

Mr. Nesbett: No, Your Honor, I would like to save time, the same as you.

The Court: It will save time to offer them as admissions of the plaintiff now. [108]

Mr. Nesbett: I will do that.

The Court: They may be admitted and marked Plaintiff's Exhibits 1 to 9.

PLAINTIFF'S EXHIBIT No. 1

So. Naknek, Alaska,
Mar. 30, 1948.

Edward D. Coffey,
Anchorage, Alaska.

Dear Sir:

At this time I am writing concerning an insurance policy covering my new restaurant in So. Naknek,

(Testimony of Joseph Sheahan.)

Alaska, which houses private living quarters on the second floor and the restaurant on the first floor.

Please inform me as to the type or types of policies necessary to insure the building and all fixtures including automatic pump, light plant, dishes, meat saw, and food supplies.

What form of policy is necessary to cover a seasonal beer and wine supply brought in in the fall valued at (\$3,000.00), three thousand dollars?

Sincerely,

/s/ ANTONIO POLIMENI.

[Endorsed]: Filed August 22, 1950.

PLAINTIFF'S EXHIBIT No. 2

April 9, 1948.

Mr. Antonio Polimeni,
South Naknek, Alaska.

Dear Mr. Polimeni:

Re: Fire Insurance on Building occupied as
Restaurant & Dwelling

In reply to your letter of March 30th wish to advise that the fire insurance rate on both building and contents is \$3.00 per \$100 of insurance for one year.

It is necessary to place a specific amount of insurance on the building and a specific amount on equipment and supplies. Beer and wine would be insured

(Testimony of Joseph Sheahan.)

under stock. We enclose form which indicates how the insurance is divided.

If insurance is ordered, we will need to have a description of the location of the property. If the land is unsurveyed so you cannot give us lot and block numbers, please advise how far distant your building is from the Post Office or the Public School Building. Also advise the construction and occupancy of any buildings within 100 feet of your building.

We trust this is the information you desire.

Very truly yours,

EDW. D. COFFEY.

PLAINTIFF'S EXHIBIT No. 3

South Naknek, Alaska,
April 17, 1948.

Edward D. Coffey,
Anchorage, Alaska.

Dear Sir:

Having received your reply to my inquiry concerning my insurance, I am supplying necessary description of the property and equipment.

The main restaurant building is (1000') one thousand feet from the South Naknek Territorial School Building and approximately (300') three hundred feet from the Post Office.

1. Main Building: 30'-30'

Restaurant—two story building housing booths,

(Testimony of Joseph Sheahan.)

counter, kitchen, pastry room, laundry on the first floor, with five rooms on second floor for living quarters for owner and hired assistants, and basement (18'-20') eighteen by twenty feet providing storage capacity for restaurant supplies and special compartment for automatic pump connected to the well inclosed within the building with descent from kitchen. Attached to kitchen and pertaining to service thereof are kitchen range, hot and cold water tank, and sink.

2. 8'-10' building 50' from main building

This building is used for housing light plant providing electrical power for restaurant and used as a repair shop.

3. 6'-8' 20 feet from main building

Separate restrooms with shields for entrances. These buildings mentioned have tin roofs and are to be insured en masse for (\$6,000.00) six thousand dollars.

Equipment and Supplies

Furniture:

Five beds complete with all season bedding, three wardrobe bureaus with clothing of owner and assistant, six chairs, two tables, one sewing machine, and one phonograph (electric).

Fixtures:

Washing machine, electric iron, complete line of China and silverware for serving one hundred capacity, and bowls, platters, and beer and wine glasses.

(Testimony of Joseph Sheahan.)

Machinery:

Gasoline engine, automatic water pump, 8 K.W. light plant.

The furniture, fixtures, and machinery are to be insured for (\$1,500.00) fifteen hundred dollars.

Stock:

Complete line of food supplies for restaurant operation for six months including small amounts of beer and wine. The stock is to be insured for (\$2,500.00) two thousand five hundred dollars.

I trust this is the complete and necessary description for my insurance application.

Thank you.

Sincerely,

/s/ ANTONIO POLIMENTI.

Received April 24, 1948.

PLAINTIFF'S EXHIBIT No. 4

So. Naknek, Alaska,
June 1, 1948.

Ed. Coffey,
Anchorage, Alaska.

Dear Mr. Coffey:

I have written you before concerning my insurance for my restaurant and I have received no reply.

I would like to hear from you immediately and learn the particulars and premium of the policy.

(Testimony of Joseph Sheahan.)

Are there corrections to be made or what needs to be done?

Please reply immediately.

Thank you.

Sincerely,

/s/ ANTONIO POLIMENI.

PLAINTIFF'S EXHIBIT No. 5

June 4, 1948.

Mr. Antonio Polimeni,
South Naknek, Alaska.
Dr. Mr. Polimeni:

Re: Fire Insurance on Building occupied
as Restaurant & Dwg.

We are in receipt of your letter of June 1st in regard to your insurance. We wrote you the following letter, mailed April 9, 1948, but evidently it was lost, so we will quote same:

“In reply to your letter of March 30th wish to advise that the fire insurance rate on both building and contents is \$3.00 per \$100 of insurance for one year.

“It is necessary to place a specific amount of Insurance on the building and a specific amount on equipment and supplies. Beer and wine would be insured under stock. We enclose form which indicates how the insurance is divided.

“If insurance is ordered, we will need to have a

(Testimony of Joseph Sheahan.)

description of the location of the property. If the land is unsurveyed so you cannot give us lot and block numbers, please advise how far distant your building is from the Post Office or the Public School Building. Also advise the construction and occupancy of any buildings within 100 feet of your building."

We trust that this is the information you desire.

Yours very truly,

EDW. D. COFFEY.

PLAINTIFF'S EXHIBIT No. 6

Edward D. Coffey
General Insurance
Anchorage, Alaska

July 23, 1948.

Mr. Antonio Polimeni,
South Naknek, Alaska.

Dear Mr. Polimeni:

Re: Fire Insurance on Building occupied
as Restaurant & Dwg.

We wish to apologize for having mislaid your letter of April 17 giving us the details of the property you wish to have insured. We enclose herewith copy of your letter for reference as we need the following breakdown before we can issue policies:

Building No. 1.—Please designate a specific

(Testimony of Joseph Sheahan.)

amount on the building and a specific amount on the equipment.

Building No. 2.—Specific amount on building.

Building No. 3.—Specific amount on building and specific amount on 8 K.W. light plant.

We assume the stock of food supplies is contained within the restaurant and no other building.

Will you kindly give us this information so we may issue your policies.

Very truly yours,

EDW. D. COFFEY,

By /s/ M. KASER.

PLAINTIFF'S EXHIBIT No. 7

Hal M. Marchbanks
United States Commissioner
Kvichak Precinct
Naknek, Alaska

August 2, 1948.

Mr. Edward D. Coffey,
General Insurance,
Anchorage, Alaska.

Dear Mr. Coffey:

Re: Fire Ins. on Building occupied as
Restaurant & Dwelling.

I am writing this letter to advise you the building as above described, burned and the policy also burned so it is impossible to supply it with this letter.

(Testimony of Joseph Sheahan.)

He wishes to put in a claim for the building.

Kindly advise Mr. Antonio Polimeni, of South Naknek, Alaska, of the procedure he is to take.

Sincerely yours,

/s/ HAL M. MARCHBANKS,

United States Commissioner.

HMM:ib

Received August 5, 1948.

PLAINTIFF'S EXHIBIT No. 8

Signal Corps, United States Army
Alaska Communication System

Telegram

Anchorage, Alaska,
Aug. 5, 1948.

HAL M. MARCHBANKS,
U. S. COMMISSIONER,
NAKNEK, ALASKA.

Relet Antonio Polimeni No Insurance In Force as We Have Received No Reply To Our Letters of June Fourth and July 23 Requesting Value Break-down On Building and Equipment Policies On Unprotected Restaurants Have To Be Ordered From Seattle.

EDW. D. COFFEY.

Night Letter

Charge Main 136

(Testimony of Joseph Sheahan.)

PLAINTIFF'S EXHIBIT No. 9

August 5, 1948.

Mr. Antonio Polimeni,
South Naknek, Alaska.

Dear Mr. Polimeni:

Re: Insurance Application

We have just received a letter from Mr. Marchbanks stating your new dwelling and restaurant burned. He did not indicate the date of loss. We are very sorry to have to advise you that not having received a reply to our letters of June 4th and July 23rd we could not order the insurance from the Insurance Company in Seattle. We do not have authority to write unprotected restaurants in our own office, and have to place all applications with Seattle offices. Very few companies will write restaurant occupancies in locations having no fire protection, such as a Volunteer Fire Department. We would have had to place this risk through Lloyds, London and we cannot submit an application until we have all the required information, which we did not have on your property.

We are extremely sorry you were unable to reply to our letters so we could have ordered the insurance.

Yours very truly,

EDW. D. COFFEY,

By

GM
encl

(Testimony of Joseph Sheahan.)

Mr. Renfrew: Are they counsel's copy of the pleadings in this case.

Mr. Nesbett: They are copies of the exhibits to Mr. Renfrew's answer.

Mr. Renfrew: They are your copy of a pleading served on you.

Mr. Nesbett: Yes.

Mr. Renfrew: I will object to them as not the best evidence. I have the originals here and I want to put them in.

Mr. Nesbett: Put in your originals.

Mr. Renfrew: I am going to.

The Court: In the meantime he wants to avail himself of time. You are offering carbon copies of the originals?

Mr. Nesbett: Yes, sir. Attached to the answer.

The Court: If they are carbon copies of the originals they are originals and the objection will be overruled.

Mr. Renfrew: They are not carbon copies of the original?

Mr. Nesbett: No, how could they be? [109]

The Court: Then you better call for the production of the originals.

Mr. Nesbett: Well, Your Honor, how do you suggest we do this. I would have introduced all the letters I have and Mr. Renfrew has the others.

Mr. Renfrew: If he wishes to call on me for the originals I have I will produce them.

The Court: If he has not the originals and you

(Testimony of Joseph Sheahan.)

have the originals he has the right to demand from you the originals he hasn't got.

Mr. Renfrew: That is what I have been saying.

Mr. Nesbett: Mr. Renfrew, will you kindly produce yours and I will produce mine.

Mr. Renfrew: With the greatest of pleasure, sir. It is understood, Your Honor, that these are being offered as exhibits by the plaintiff. I furnish the letter of March 30th, which may or may not be in the actual enumeration of the exhibits, might not correspond with the number in the pleadings, if not they will confuse the record, but I tender to you first the letter of March 30th.

The Court: I am inclined to think, however, that the exhibits should be marked in chronological order.

Mr. Renfrew: I think they should. The letter of March 30th is the first letter of Polimeni. I suggest that counsel submit the letter of April 9th, which was in reply to [110] the letter of March 30th.

Mr. Nesbett: Your Honor, I don't have the original of the letter of April 9th. Mr. Polimeni wrote his letters in longhand, or the school teacher did.

Mr. Renfrew: You must be confused. The letter of March 30th is Mr. Polimeni's letter, and you have the letter from Mr. Coffey, dated April 9th.

Mr. Nesbett: No, I haven't got that one.

Mr. Renfrew: Where did you get a copy of it?

Mr. Nesbett: You very kindly put it in your pleading.

Mr. Renfrew: Alright, I will stipulate. May I

(Testimony of Joseph Sheahan.)

find out if this is a carbon of the original, sir?

The Court: Yes.

Mr. Renfrew: Is that a carbon of the original?
I will tender a carbon copy of the original letter.

The Court: It may be admitted.

Mr. Renfrew: That is 1. This will be 2.

Deputy Clerk: That is right.

Mr. Renfrew: Then I tender, Your Honor, a letter dated April 17th, which is the original letter of Mr. Polimeni, as Exhibit Number 3.

Mr. Nesbett: No objection.

Mr. Renfrew: You are offering these. I am not.
I am tendering them to you. [111]

Mr. Nesbett: Alright.

Mr. Renfrew: Then I tender the letter of June 1st, 1948, as Exhibit 4, which is the original letter of Mr. Polimeni. Then I will call upon counsel to produce the original of the letter of June 4th.

Mr. Nesbett: Let's see. I have not got it, Your Honor.

Mr. Renfrew: What have you got there?

Mr. Nesbett: Will you stipulate that that copy can go in?

Mr. Renfrew: Is this a carbon copy of the original letter?

Mr. Nesbett: This is a carbon copy of the original letter.

Mr. Renfrew: The next correspondence should be July 23rd. Do you have that?

Mr. Nesbett: Yes, I have that.

Mr. Renfrew: That will be five.

(Testimony of Joseph Sheahan.)

Deputy Clerk: Six.

Mr. Renfrew: The next is the original letter of Mr. Marchbanks, which appears to be number seven. You have the telegram?

Mr. Nesbett: I think I have that. Is that to Marchbanks?

Mr. Renfrew: That is the August 5th telegram. [112]

Mr. Nesbett: No.

Mr. Renfrew: I will tender the carbon copy of the telegram of August 5th. You have the letter to Mr. Polimeni of August 5th?

Mr. Nesbett: No, I haven't.

Deputy Clerk: The telegram is Plaintiff's Exhibit 8.

Mr. Renfrew: Then I will submit the carbon copy of the letter of August 5th, confirming the telegram.

Deputy Clerk: Defendant's Exhibit 9.

Mr. Renfrew: Now, before we proceed may I get the chronological order of those. The March 30th letter is that plaintiff's exhibit 1?

Deputy Clerk: Yes.

Mr. Renfrew: The April 9th letter is Plaintiff's Exhibit 2?

Deputy Clerk: Yes.

Mr. Nesbett: Do you have any objection to allowing the witness to look at Exhibits 1 through 9 as attached to your answer?

Mr. Renfrew: He can look at the Sears-Roebuck catalogue so far as I am concerned.

Q. (By Mr. Nesbett): Referring to Exhibit

(Testimony of Joseph Sheahan.)

No. 1, Mr. Sheahan, would you mind glancing through that hurriedly? [113] A. Surely.

Q. And Exhibit 2, the letter of April 9th following after that. Now, Mr. Sheahan, the letter of April 17th, will you examine that letter, please.

A. April 17th?

Q. Yes.

A. It is to Edward D. Coffey, Anchorage, Alaska.
Dear Sir——

The Court: You don't have to read it. Just read it to yourself and consider it. I mean you don't have to read it aloud.

A. Yes. That man ordered insurance.

Q. The letter of April 17th is an order for insurance according to the custom of the insurance world, Mr. Sheahan? A. Yes.

Q. What would have been the ordinary procedure for the agent to follow upon receipt of an order?

A. The agent in this case needed a little more information.

Q. What did he need?

A. He naturally wanted to know how much insurance would be placed on each building.

Q. That is right. Now that was the only thing lacking, was it not?

A. Yes, I would say so. He would have to know how much insurance to apply on each building and how much on equipment in each building. [114]

Q. Could the agent according to the general

(Testimony of Joseph Sheahan.)

practice have gone ahead and effected a temporary coverage without that information?

A. I would say yes.

Q. How could he have accomplished that, Mr. Sheahan?

A. By having written a letter to the insured, telling him he was covered, and to have asked him to send the additional information, that is how much on each building.

Q. Then, Mr. Sheahan——

A. Beg pardon.

Q. How would the agent have procured the coverage? A. He has authority——

Mr. Renfrew: We object to this question and we move the last answer be stricken on the ground that it never had any effect on Mr. Coffey, unless it is shown Mr. Coffey had authority. I submit, Your Honor, if the agent did not have the authority to bind that wouldn't bind him in any shape or form.

Mr. Nesbett: It goes back to the custom between the agent and his parent company.

The Court: You would have to show that the general customs of the business encompassed this.

Mr. Nesbett: The answer was not stricken?

The Court: No.

Q. I will ask you this. Is your last answer based on the [115] custom followed by insurance agents throughout the United States and Alaska? You understand my question?

A. Very well. An agent has an authority to bind ordinarily——ordinarily according to his judgment.

(Testimony of Joseph Sheahan.)

Q. Within limits?

A. Your judgment limits that, yes.

Q. Will you amplify on that answer, if you please, so the Court and jury will understand just what you mean?

A. Yes. South Naknek is naturally an unprotected area. They have no fire department, I believe, and so when you have a fire down there you can just pray for rain and that is about all, and so you won't go as far as you would in Anchorage or Palmer in writing insurance. I would say that I would go twenty-five hundred dollars in any of my companies down there.

Q. Twenty-five hundred in any of your companies? A. Yes.

Q. Could you have effected the insurance coverage of ten thousand dollars by binding four companies on four separate policies?

A. Oh, yes.

Mr. Renfrew: Object to that answer and the one previous and ask it be stricken and the jury instructed. What this man did or could have done is not binding on Mr. Coffey.

Mr. Nesbett: He says it is based on custom and usage. [116]

Mr. Renfrew: The custom and usage he says he could have bound in the companies he has. Mr. Coffey didn't. He had only two companies and he was limited to fifteen hundred dollars in each company.

(Testimony of Joseph Sheahan.)

The Court: It seems to me here the question is not custom and usage, but specific authority.

Mr. Nesbett: I expect to show Mr. Coffey had more authority than he testified to.

Mr. Renfrew: Why don't you?

The Court: If you intend to make a showing of that kind this evidence will be permitted, but it will be stricken unless you connect it up.

Mr. Renfrew: How could this be connected up with that? We can bring in ten agents with different authority. That won't impeach Mr. Coffey. He can't do it by asking this man what authority he has.

The Court: Of course, in making a showing of that kind he is not limited to the questions he asks

Q. Mr. Sheahan, I believe you testified, did you of this witness. He may call several other witnesses to the stand, but if he is to be permitted to make that showing he cannot be limited to this.

Mr. Nesbett: Your Honor, may we have a five minute recess.

The Court: We will recess five minutes. [117]

(After a short recess Court is reconvened at 11:20 o'clock a.m., April 18th, 1950.)

JOSEPH SHEAHAN

having previously been called as a witness on behalf of the plaintiff, resumes the witness stand and testifies as follows on

Further Direct Examination

By Mr. Nesbett:

(Testimony of Joseph Sheahan.)

not that your association with Mr. Coffey terminated on January 22nd, 1948?

A. That is right.

Q. Now, Mr. Sheahan, if you had received that letter of April 17th on January 21st of 1948, while you were still associated with Mr. Coffey, could you through Mr. Coffey's companies have effected a ten thousand dollar coverage on Mr. Polimeni's restaurant?

Mr. Renfrew: Objected to as immaterial and irrelevant what he could have done on the 21st of January.

Mr. Nesbett: It was only two or three months in Mr. Coffey's office there before the time that letter was written, and it is relevant whether or not he could have effected that coverage manipulating Mr. Coffey's power.

The Court: Objection overruled. [118]

Mr. Renfrew: What was the date of the termination again?

Mr. Nesbett: January 22nd, 1948.

Q. You may answer that question, Mr. Sheahan?

A. Yes. I would have put twenty-five hundred dollars, or perhaps fifteen hundred in an American company and wired to Lloyds in Seattle.

Q. In Seattle?

A. For the balance.

Q. Would you have requested telegraphic confirmation, Mr. Sheahan, as a general practice?

A. Yes. Oh, yes they wire right back, usually the next day.

(Testimony of Joseph Sheahan.)

Q. Mr. Sheahan, what is the practice, or what was the practice in Mr. Coffey's office with respect to telegraphic requests and telegraphic confirmations as of January 22nd, when you terminated?

A. We telegraphed for coverage. We would ask for a reply immediately—confirmation in other words.

Q. What was the policy in Mr. Coffey's office with respect to paying for these telegrams? I mean by that would he require the customer to pay that, or would you pay it?

A. No, we paid it.

Q. Was that the general rule?

A. I believe for all of mine.

Q. Can you state generally how long would it have taken to [119] effect this additional coverage with Lloyds?

A. With a small amount like seventy-five hundred, that is all the policy we would have issued in excess of the warranty policy, we would get an answer the next day.

Q. Mr. Sheahan, in that situation we have just gone over when would Mr. Polimeni's coverage have commenced?

Mr. Renfrew: May I have his question again.

(Reporter reads the last question.)

Mr. Renfrew: I object to the form of the question. I don't see how it could be answered intelligently.

Mr. Nesbett: I have gone over it step by step.

The Court: I think the question is somewhat indefinite in form. If you want to show whether or

(Testimony of Joseph Sheahan.)

not after approval it would have been made retro-active to a certain time, or some other event of the transaction, you could do that.

Mr. Nesbett: I thought that would be covered in the answer. He could say either on receipt of the confirmation or receipt of the letter it was good coverage.

The Court: If he would answer it that way, but he is looking through the file as if to ascertain the date of some letter.

Mr. Nesbitt: If the witness can answer would Your Honor permit him?

The Court: Yes.

A. A letter dated July 23, 1948, addressed to Mr. Antonio [120] Polimeni, signed by Grace McConnell, says——

Q. Just a moment, I am not concerned with that letter, Mr. Sheahan. I am concerned with the letter of April 17th. What the agent did or would have done in the usual course of business toward effecting insurance coverage.

A. The usual course of business when the first letter from Mr. Polimeni was received you would turn the business down. You would have asked him exactly like the Coffey Agency did how far removed other buildings were from the premises there.

The Court: That isn't the question. The question, as I understand it, is when would the insurance take effect once approved.

(Testimony of Joseph Sheahan.)

A. Once approved? On July 23rd they state, "Will you kindly give us this information, so we may issue your policies."

The Court: I think that the witness——

Mr. Nesbett: May I proceed, Your Honor?

The Court: Yes.

Q. We were discussing the letter of April 17th, containing that information. I asked you what the agent would have done on receipt of that letter in the usual course of business.

A. He would have bound the coverage right then, but written exactly the same letter he did, asking how much insurance he wanted on each building.

Q. Then, Mr. Polimeni would have been covered at the time the agent wired and placed part of the request on the warranty company? [121]

A. That is right.

Q. You could have done that on January 21st under the usual procedure and the authority of Mr. Coffey's position could you not?

A. I hate to say it, but I could have, yes.

Q. Well, all we ask, Mr. Sheahan, is that you tell the truth regardless. You are not here of your own free will and accord.

Mr. Renfrew: Object to this prejudicial explanation that is going on.

The Court: Remarks of that kind should be avoided.

Mr. Nesbett: That is all, Your Honor.

(Testimony of Joseph Sheahan.)

Cross-Examination

By Mr. Renfrew:

Q. Mr. Sheahan, you stated you have been in the insurance business for thirty some odd years, I believe. A. That is right.

Q. Were you ever in business for yourself until you came to Alaska? A. No.

Q. You have always worked for someone else until you left Mr. Coffey's employ?

A. Yes, for a little while I was in business for myself, and [122] another agent bought it out, but not very long.

Q. Your principal experience has been that of insurance salesman, has it not?

A. That is right.

Q. Have you always familiarized yourself with the company's policy as to paying for telegrams and things of that nature, or did you just assume they did?

A. No, I was with one company for twenty-five years, the largest company in Oregon and they paid for theirs.

Q. Is that the reason you testified Mr. Coffey paid for his, because the agent in Oregon did?

A. No, but the agency in Oregon is fifty times as big as Coffey and I assumed——

Q. In other words, you are testifying not from what you know, but what you assume.

A. My bill for telegrams runs around a hundred and twenty dollars a month.

(Testimony of Joseph Sheahan.)

Q. And you pay for it yourself?

A. Yes.

Q. Occasionally, on airplanes I know Ed used to charge people for telegrams.

Q. Now, to get down to this case, Mr. Sheahan, I believe you testified that upon receipt of the letter of April 17th, which you have looked at and which is the letter purporting to give the information upon which the insurance was to be written, [123] that you could have covered the prospective customer by writing, excuse me, by writing him and telling him you would cover him and then asking how much insurance he wanted on each building.

A. I would have wired him.

Q. That would have been a matter of just your personal way of doing business?

A. If a man wants insurance he wants it right now and you just as well wire, I think.

Q. Actually you could not have bound that insurance without further information?

A. Yes, I could have bound it and then asked him for the information.

Q. Now then, there are three buildings involved in that application of April 17th. Supposing you say you are bound, Mr. Polimeni, but I have to know how much you want on each building.

A. That is what I would have done.

Q. Before he can answer this the main building burns down. How much would you pay out?

A. The actual value of the building.

(Testimony of Joseph Sheahan.)

Q. But you haven't any contract with him at that price? A. No.

Q. You think your company would have been bound if you had wired? [124]

A. Yes, I do, and furthermore you once came from Naknek and you said you wanted some insurance for somebody down there and I said it is covered.

Q. That is very possible. I don't remember it. But were they covered?

A. They were covered if I said so.

Q. As a matter of fact you said the Alaska Sportsman was covered when they weren't. That is the airplane that cracked up?

A. That is not——

Q. That is a horse on you.

Mr. Nesbett: Just a moment——

A. No, that is not accurate at all.

Q. You——

Mr. Nesbett: Just a moment. Let him answer the question.

The Court: Isn't he answering?

Mr. Nesbett: Mr. Renfrew is trying to butt in.

Mr. Renfrew: No, I'm not.

A. You are talking about the——(Inaudible)

Q. No, about the boy up at Sheep Mountain and your company said they are not bound, you had no authority.

A. No, you are talking about Lloyds and we have no binding authority on Lloyds.

(Testimony of Joseph Sheahan.)

Q. Mr. Sheahan, just a moment ago you wanted to place this [125] insurance with Lloyds?

A. I wanted to wire Lloyds and get an answer back.

Q. In other words, you would have written Polimeni you are insured, but you wouldn't have covered him until you got a confirmation from Lloyds?

A. I would have gotten it the next day and I would have wired Polimeni as soon as I got the confirmation, yes.

Q. Aren't you assuming something, Mr. Sheahan? Do you think Lloyd's would have covered an unprotected risk over in Naknek without information as to the value of the different buildings and without more definite information as to the moral risk involved?

A. The moral risk hasn't been brought up yet.

Q. Isn't that something to take into consideration?

A. If it is a moral risk we give consideration to that, yes, but Lloyds have a hundred and sixty thousand dollars on Larry's, Inc., out here outside of town, no fire protection. Does that answer your question?

Q. That is open market coverage?

A. It is open market, and something off contract.

Q. As long as we are going to have a school here on insurance, in order to get open market insurance you have to submit it clear to London and open for bids?

A. Yes.

Q. There isn't anybody that takes all hundred

(Testimony of Joseph Sheahan.)

and sixty [126] thousand dollars, they would take a portion.

A. Say you wanted fifteen thousand dollars off a contract. They would take that.

Q. You say back in January of 1948, while you were still in the employ of Mr. Coffey, you would have and could have bound Mr. Polimeni from the information contained in the letter of April 17th. Will you state by virtue of what authority as a salesman for Mr. Coffey that you could have bound ten thousand dollars on one risk and one company he had authority to bind.

A. I would have put that in four companies, that is the twenty-five hundred dollars, and using that company as a warranty company I would have wired Lloyds and asked them to cover the other seventy-five hundred.

Q. These four companies you would have bound it in in the amount of twenty-five hundred dollars, assuming now that you know and you are testifying from your personal knowledge of the companies, what companies would Mr. Coffey have authority to bind an unprotected risk in, even twenty-five hundred, on January 21st?

A. I say fifteen hundred or twenty-five hundred.

Q. What four companies?

A. Let's make it twenty-five hundred. Philadelphia Fire & Marine, Canadian Fire, the General Insurance Company of America, Fidelity & Warranty Fire. There is four.

Q. Is it your testimony that when you left there

(Testimony of Joseph Sheahan.)

in January [127] that the Philadelphia Fire Insurance—that Mr. Coffey had binding authority, that he could have bound them to the tune of twenty-five hundred dollars on an unprotected risk in Naknek?

A. I think so. One of the four would have taken twenty-five hundred and that is all we need to wire Lloyds.

Q. One of the four? A. Yes.

Q. Would you have told Mr. Polimeni he was bound without finding out which one of those four would have taken it?

A. I would have known at that time. It has been quite awhile since I have been there. I would have known then which company would take it.

Q. What you are testifying now to is that he had at least four companies and you are sure one of them would have taken an unprotected risk, but you don't know which one?

A. He had more than four.

Q. You take Frank Burns. They might have had five companies under Frank Burns. Would they be all under the same authority under Frank Burns?

A. No. Different companies have different practices. A general agent like Frank Burns reflects the attitude of the companies it represents.

Q. Take Cravens, Dargan & Company itself. Probably an agent would have several companies handled through Cravens-Dargan but [128] Crav-

(Testimony of Joseph Sheahan.)

ens-Dargan would set the policy with the local agent here?

A. No, the companies tell Cravens-Dargan what they want to do. They are the general agents.

Q. I herewith hand you a copy of a letter, and being an insurance man I will just ask you to go over that and if you want to change your answer.

A. No, I won't change my answer on the basis of this one letter from one company, that is Cravens-Dargan.

Q. Isn't it true that Cravens-Dargan have a number of insurance companies?

A. Oh, yes. They have some like the Sun Insurance Company, who write fifteen hundred dollars on this and that, and not very many companies——

Q. They are not a very big outfit, Cravens-Dargan?

A. Cravens-Dargan are not big themselves.

Q. They are about the biggest outfit on the Pacific Coast.

A. No, I think not. This letter refers to Beaudin doing business as the Five Fifteen Club and this particular company don't want any coverage on bars.

Q. Is that question discussed?

A. "You know this type of occupancy has always been considered borderline as far as fire insurance is concerned. At the present time we understand that due to a great drop in business the moral hazard is increasing rapidly. Therefore Mr. Cravens has made a strict ruling that we are to write no

(Testimony of Joseph Sheahan.)

night clubs, [129] clubs, bars, or unprotected restaurants. We are very sorry and so forth.”

Mr. Nesbett: What is the date of it?

Mr. Renfrew: January 23rd, 1948.

Q. That is right after, that is the day after you left Coffey? A. Yes.

Q. Unprotected means unprotected fire areas?

A. In view of this letter we wouldn't have wired Cravens-Dargan.

Q. If you had been there on the 17th of April, when the application came in——

A. Just a moment.

Q. Sure.

A. That was Cravens-Dargan's own idea of underwriting. I don't go out after bar business, but I do have the Denali Bar and I have Fred Mayer.

Q. I submit that is not answering my question.

A. This is just their idea of underwriting, but other companies do take the bars. I have the Frontier Bar. I have Larry's Inc. I have the Anchorage Liquor Store.

Q. You are doing a whale of a business, but it doesn't interest us in this particular instance.

A. I am telling you that this is their own idea and it doesn't——

Q. The same is true of agents, isn't it? One agent will [130] keep the better business and keep the same business for twenty-five years?

A. Yes.

Q. And another would be not so careful and his business would fall off? A. Yes.

(Testimony of Joseph Sheahan.)

Q. And didn't this happen to you just recently?

A. Yes it has.

The Court: We will recess at this time until 2 o'clock.

(Whereupon, at 12 o'clock noon the court recessed until 2 o'clock the same day.)

Afternoon Session

The Court: You may call your next witness.

Mr. Nesbett: We had Mr. Sheahan on the stand, I believe, Your Honor.

The Court: Very well. He may resume the stand.

JOSEPH SHEAHAN

being previously called as a witness on behalf of the plaintiff resumes the stand and testifies as follows on

Further Cross-Examination

By Mr. Renfrew:

Q. Mr. Sheahan, I believe that you testified this morning [131] that if you had received the letter of April 17th as an agent and it contained the information that it does contain in spite of the fact that it didn't say how much on any particular building that nevertheless you would have attempted to bind that by advising the customer and wiring outside. Is that the gist of your testimony?

A. Yes, but I certainly would have written the same type of letter Mr. Coffey wrote to get the proper information.

(Testimony of Joseph Sheahan.)

Q. When you say you would have bound you would have bound subject to authority from the company to bind?

A. No, I have authority from the company to bind.

Q. Well, I am asking you if you did not have the authority would you have done it anyway?

A. Oh, no. If I hadn't had authority I most certainly would not have bound it.

Q. If you couldn't have bound ten thousand dollars worth of insurance, or whatever the application called for, by virtue of lack of authority that definitely would have governed your action in the matter?

A. Naturally.

Q. You don't know whether Mr. Coffey had authority or not on April 17th to bind?

A. On April 17th, no, I don't.

Q. You had severed your connection in——

A. January. [132]

Q. In January I believe you testified?

A. That is right.

Q. And you examined that letter which was dated January 23rd, 1948, from Cravens, Dargan & Company, which clearly advises you that at least the companies Cravens-Dargan represented had pulled out of the business insofar as unprotected areas were concerned two days after you left Coffey's office?

A. That is true.

Q. I believe you also testified, Mr. Sheahan, that the judgment of the agent played an important part

(Testimony of Joseph Sheahan.)

in the placing of insurance, or the action of an agent with regard to telegraphic binders and so forth?

A. That is true.

Q. You will recall that I at one time asked you to bind something in Naknek? A. Yes.

Q. And you did bind it? A. That is right.

Q. You recognize that was a dwelling house?

A. I thought it was a store and dwelling house. I don't remember.

Q. You know it wasn't a liquor store?

A. I don't know. You changed your mind. I told you it would be covered, but we didn't go any further with it.

Q. Now, if you were an agent and you had received the letter [133] of the 17th and if you had had a previous experience with the applicant that he had had one fire loss would that have influenced you any?

A. Not if that was an honest fire, no.

Q. Supposing he had had two losses?

A. That wouldn't make any difference.

Q. As a matter of fact, don't some companies—aren't they a little reluctant to reinsure a man who has had—— A. If they——

Q. Just a moment, till I ask the question. Are some companies reluctant to reinsure when a man has had two in a short time?

A. Suspicious fires, yes, and I wouldn't even refer one to a company.

Q. Did you know that Mr. Polimeni had had

(Testimony of Joseph Sheahan.)

two fire losses, one over at Chignik and one at Naknek? A. Never heard it.

Q. Don't you think an agent would stick his neck out by binding something like that?

A. I should consider it.

Q. The Cravens Dargan Company, I believe you mentioned this morning, had a little company, the Sun, that takes fifteen hundred dollars?

A. I believe they have.

Q. I believe you know that Cravens-Dargan have nothing to do [134] with the Sun?

A. I think Swett & Crawford have that.

Q. Then you were in error?

A. I was, an honest error, yes.

Q. You mentioned you were embarrassed and it was with great reluctance you made these statements. As a matter of fact, you were discharged by Mr. Coffey?

A. No, sir. I never was discharged by Mr. Coffey. I told him I wanted to leave. We were having a ride one day.

Q. It isn't true Mr. Coffey made a special trip up from the States for the purpose of getting the keys from you?

A. If he ever did he didn't tell me so, and further than that I think the reason Mr. Coffey came up here was that my former partner and I the day before rented an office, two days before in the Loussac-Sogn Building, and I thought Mr. Coffey had heard about it.

Q. Mr. Sheahan, we were just on the verge of

(Testimony of Joseph Sheahan.)

discussing the various agents and the companies they are able to keep. Now, an agent that is careful of his risks never loses a company, does he?

A. Oh, yes, he might.

Q. As a general thing it would be extremely unusual circumstances that would cause them to withdraw?

A. Usually, but you might have an agent here in town giving a company a fine business, while Fairbanks has had a disastrous [135] experience. A good many companies have pulled out of the Territory because of the experience in Fairbanks.

Q. Loss experience? A. Loss experience.

Q. They are making money at this time?

A. That is true.

Q. And some agents are able to keep companies for years and years, and others will go out and write anything to make a premium?

A. That is true.

Q. Technically speaking, Mr. Sheahan, under no circumstances could an agent write a policy on three buildings without knowing how much on each building without getting into a lot of trouble, could he?

A. I know several ways of doing it. We can write a lump sum on three buildings by writing the policy with a co-insurance clause or a distribution clause.

Q. Is it your understanding, Mr. Sheahan, that before a policy of insurance could be written there had to be a mutual meeting of the minds between the insured and the insurer? A. Sure.

(Testimony of Joseph Sheahan.)

Q. And such could not be the case if you undertook to insure three buildings you never saw before and set an arbitrary value on each of them when he wanted an overall amount?

A. I will answer in a round about way. [136]

Q. Answer it. A. Alright, starting on——

Q. I say you couldn't have any meeting of the minds if an application came in from a man who said he wanted to insure three buildings for a certain amount of money but you divide it by three and put it on each building?

A. I wouldn't undertake to do that, but I could cover each building temporarily until he gave me the values on each one.

Q. I ask you how you can do that?

A. You can do that merely by referring to the back of your mind the policy, which says that the company will not be responsible for more than the actual value of the property at the time the loss occurs. If the man were trying to obtain too much insurance he wouldn't collect it anyway. I would write a place as remote as Naknek and ask him how much he wanted on each building, but in the meantime I would certainly protect it.

Q. If a man wrote in from Naknek and said he had three buildings he wanted to insure for three thousand dollars you would write back and say you are bound but write back and tell me which building is which?

A. That is true, and how much on each one.

(Testimony of Joseph Sheahan.)

Q. What would you do if the buildings burned down in the meantime?

A. It doesn't make any difference how much insurance you have. [137]

Q. You just stated you could only collect the actual value?

A. Yes, but he can send these amounts then we can insure all of them.

Q. We are not interested in that, Mr. Sheahan. We are following the example of Mr. Polimeni's hypothetical case. If all those buildings were destroyed by fire and you had told Mr. Polimeni in a wire that you were bound you would individually be stuck?

A. No, I have power to bind my companies.

Q. Does your company give you power to bind an arbitrary figure?

A. Yes, to use my best judgment.

Q. And that would be your best judgment?

A. My judgment would be in Naknek to put that ten thousand dollars in four or five companies.

Q. What your judgment would be and what Mr. Coffey's judgment might be might not be the same?

A. That is true.

Q. In one case he might have better judgment and in another case you have better judgment?

A. Yes.

Mr. Renfrew: That is all. [138]

(Testimony of Joseph Sheahan.)

Redirect Examination

By Mr. Nesbett:

Q. Is it common practice to cover him after you receive most of the information necessary?

A. I would have covered him right away, but that is just my way of operating and has no reflection on anyone else's operation.

Q. You have been in the insurance business thirty-two years or thereabout? A. Yes.

Q. Is that the general practice?

A. If a company has confidence in its agents they let them do that, at least you are an agent for the company and if you say yes it is covered it is covered.

Q. Let's go a little further into this. Suppose in Mr. Polimeni's situation this letter of April 17th was received and you have placed twenty-five hundred dollars in a warranty company and wired Seattle for a confirmation on the seventy-five hundred and that confirmation was received the following day, would it be general practice then to issue a policy to Mr. Polimeni?

A. No, it normally would if he was here in town, but Lloyd's issue their own in Seattle. I wouldn't have used Lloyds in this particular case. I would have used about four or five stock companies. [139]

Q. Right after confirmation was received in that situation what date would you put on the policy?

A. The date the order was given.

Q. In other words, it amounts to predating the

(Testimony of Joseph Sheahan.)

policy to the date of the application, does it not?

A. Yes, you get busy in an insurance office and somebody wants insurance today and you don't write the policy for a week. You date it back.

Q. But you have the application and you have agreed that he is bound?

A. Yes, the application is usually a memo, is, oh a memo giving the name and address of the applicant and the amount of insurance he wants.

Q. What is that memorandum called in the insurance world?

A. It is a sheet of scratch paper often times. Sometimes you have printed memos.

Q. Is it called a binder?

A. No, it is called a what? Let's see now, we do have binders too. A binder is temporary. It covers a person usually for thirty days subject to all terms and conditions of the standard fire insurance policy, or until such time prior to the thirty days that the policy could be issued—the policy itself can be issued.

Q. Could a binder have been used in this situation, Mr. Sheahan? [140]

A. I don't know whether Ed had binders. I think he did. I don't know. Some he did and some he didn't, I believe.

Q. Now—— A. A letter can be a binder.

Q. Assuming Cravens and Dargan were not willing to insure risks such as Mr. Polimeni applied for, from your own knowledge of Mr. Coffey's busi-

(Testimony of Joseph Sheahan.)

ness, disregarding Cravens and Dargan as a facility, could you have covered Polimeni otherwise?

A. I don't know. He has, I think, seven very good companies. I would think so, the letter stated that when they received the information they would issue his policies.

Q. What letter do you refer to? The letter of July 23rd?

A. I think so. "Will you kindly give us this information so that we may issue your policies."

Q. To whom was that addressed?

A. Mr. Antonio Polimeni and signed Edward D. Coffey by Grace McConnell. Evidently they could have written it. That is an unfortunate thing to happen.

Mr. Nesbett: May I read this letter, your Honor?

The Court: Is that a duplicate of the exhibit?

Mr. Nesbett: Yes, an exact duplicate of Plaintiff's Exhibit 6. It is a letter dated July 23rd, 1948, addressed to Mr. Polimeni, South Naknek, Alaska. "Dear Mr. Polimeni: [141] Regarding Fire Insurance on Building. We wish to apologize for having mislaid your letter of April 17th giving us the details of the property you wish to have insured. We enclose herewith copy of your letter for reference as we need the following breakdown before we can issue policies. Building No. 1. Please designate a specific amount on the building and a specific amount on the equipment. Building No. 2. Specific amount on building. Building No. 3. Specific amount on building and specific amount on 8 K.W.

(Testimony of Joseph Sheahan.)

light plant. We assume the stock of food supplies is contained within the restaurant and no other building. Will you kindly give us this information so we may issue your policies. Very truly yours, Edward D. Coffey by Grace McConnell," with certain typing notations on it.

By Mr. Nesbett:

Q. Mr. Sheahan, in your association with Mr. Coffey were you authorized to sign policies and deliver them to purchasers?

A. Oh, yes, we did. The girls signed the policies even. In my office the girls who know what they are doing——

Mr. Renfrew: Object as incompetent, irrelevant and immaterial what they do in his office.

The Court: Yes, objection sustained.

Q. Mr. Sheahan, what happened on this request that Mr. Renfrew made that you bind a certain building in Naknek?

A. Oh, he came back from Naknek and asked me to cover a building. [142] I don't recall what it was and I said it is covered and I think nothing came of it. The man was to write to Mr. Renfrew, I believe, or something, and tell him how much he wanted.

Q. Did you tell Mr. Renfrew it was covered?

A. Oh, yes.

Q. Was it covered? A. Yes, it was.

Q. If that building had burned two days later would they have received payment for their loss?

A. Yes, they would.

(Testimony of Joseph Sheahan.)

Q. Is that common practice in the insurance world? A. Yes.

Q. Mr. Sheahan, during your association with Mr. Coffey did he insure bars on occasion?

Mr. Renfrew: Object improper redirect examination.

Mr. Nesbett: It certainly is completely relevant to Mr. Renfrew's cross-examination just before lunch, where he went into the bar situation very thoroughly and so did Mr. Sheahan in his answers.

The Court: Overruled.

A. Yes, he insured bars.

Q. As a matter of fact he insured everything under the sun, didn't he?

Mr. Renfrew: I make the further objection that [143] it is incompetent, irrelevant and immaterial, calling for a conclusion. He don't insure me and I was under the sun once in a while.

Mr. Nesbett: At least you would——

The Court: Counsel shouldn't argue between themselves. It will be sustained as to that question.

Q. Wasn't it the policy of the Coffey agency during the time you were there and since that time that Coffey insures everything—remember? You remember that?

A. Very well. I am reminded of it every day.

Q. That would include bars, wouldn't it?

A. Yes, he insures bars.

Q. Regarding the meeting of the minds, Mr. Coffey, you are familiar with that correspondence

(Testimony of Joseph Sheahan.)

now, consisting of Exhibits 1 through 9, where in your opinion as an insurance man would the meeting of the minds occur?

Mr. Renfrew: Object incompetent, irrelevant and immaterial, calling for a conclusion.

A. I don't—

The Court: I don't get that.

Q. In the course of the correspondence?

The Court: Seems to me you are asking him to pass on a question of law, aren't you.

Mr. Nesbett: Yes, Your Honor, it is true, but the usage in the insurance world is important, isn't it? It [144] becomes a practice.

The Court: If you would ask the witness what kind of a showing is considered sufficient according to the general practice of an insurance agent to enable them to proceed with the issuance of a policy of insurance, even though at a later time they would have to obtain another is competent, but to admit the answer in the form in which you put it calls for an answer in a matter of law.

Mr. Nesbett: I will put Your Honor's question to Mr. Sheahan.

Q. (By Mr. Nesbett): Did you hear His Honor?

A. Yes.

Mr. Renfrew: I didn't.

The Court: Will the reporter read the question, please.

(Reporter reads the last statement of the Court.)

Q. Can you answer that question?

(Testimony of Joseph Sheahan.)

A. Yes, I think insurance goes into effect when a man asks for insurance and the agent says he is willing to write it.

The Court: But you have to know the amount and the property to be insured?

A. Oh, naturally, go out and see the building, but I am talking about insurance in general. If he comes up and says I want six thousand dollars insurance on a dwelling located at [145] such and such location, and I have no knowledge of it and I say it is covered we have a contract of insurance right there.

Mr. Nesbett: That is all, Your Honor.

Recross-Examination

By Mr. Renfrew:

Q. Would your answer be the same, Mr. Sheahan, whether or not the agent had the authority?

A. Oh, no. I think an agent that exceeds his authority is getting himself in an awful predicament.

Q. And you stated that you felt, if my recollection of your testimony is correct, that the insurance was in effect when a customer asked an agent for coverage and the agent says OK I will write it for you?

A. Yes.

Q. Would you say that would be the case if the agent didn't have the authority to bind?

A. An agent does have authority to bind. A

(Testimony of Joseph Sheahan.)

broker does not. An agent directly represents an insurance company. A broker doesn't, he goes out and places insurances with various companies, but when you make an agency agreement with a company it is a legal agreement, it is a contract and along with it comes a line of various risks the company is willing to take and the limit they are willing to go on protected and unprotected risks. You are an agent for the company. You sign policies [146] for them.

Q. You are through now? A. Yes.

Q. I will ask you the same question over again and see if you can confine your answer to the question. A. I answered the question.

Q. Yes, but we don't need decisions. If, as you indicated, in your testimony, a customer wrote in and asked for some insurance and the agent, such as yourself, or Mr. Coffey, wrote back and said you are insured, would he be insured if you didn't have authority, if your company had limited you in your authority so you didn't have the authority?

A. I would have put it in two companies then, or three.

Q. In other words, if you don't have authority you couldn't bind insurance?

A. I can't bind without authority.

Q. But you could make yourself personally responsible by sticking your neck out? A. Yes.

Q. You would make yourself personally responsible? A. Yes, that is true.

Q. One further question. In all your thirty-two

(Testimony of Joseph Sheahan.)

years of experience did you ever hear of an agent that turned down a request?

A. Oh, yes, you bet. [147]

Q. Then it is my understanding there is no duty on an agent to issue insurance policies just because a man makes an inquiry?

A. Heavens, no, we turn down risks right along.

Mr. Nesbett: Just a moment, I object as any further answer——

The Court: The witness has the right to explain his answer if the answer is the kind that requires explanation. If you wish to explain your last answer you may do so.

A. I think I finished that. I have seen lots of risks turned down, yes, rooming houses with chattel mortgages on them and things of that kind.

Q. Now, Mr. Sheahan, you have stated that in your opinion the insurance is in effect, providing the agent had the authority when the agent says you are covered?

A. That is usually the expression. You are covered right now.

Q. And that leaves nothing left to be done?

A. You usually write an insurance policy.

Q. And a little matter of the policy?

A. Oh, yes, be a lot of fire protection before the premium is paid.

Q. Yes. Now I want you to examine Plaintiff's Exhibit 1. That is the letter—no 1 is the top letter. Read that carefully and see if you feel up to that

(Testimony of Joseph Sheahan.)

time you feel there was [148] any insurance in effect?

Mr. Nesbett: Is that Exhibit 1?

Mr. Renfrew: Yes, that is Exhibit 1.

A. I don't think there is any insurance in effect.

Q. Now, I will ask you to examine Exhibit No. 2.

A. No.

Q. Is there any insurance in effect there?

A. No.

Q. Now, read Exhibit No. 3.

A. I can't see there was any insurance.

Q. There wasn't any insurance in effect then, was there, Mr. Sheahan? A. No.

Q. Now, read Exhibit No. 4. Any insurance in effect there, Mr. Sheahan? A. No.

Q. Your answer is no? A. No.

Q. Now read Exhibit No. 5.

The Court: I don't think the plaintiff claims there was any insurance in effect at any time.

Mr. Renfrew: Alright. Your Honor has allowed him to interrogate this witness as to what he would have done under similar circumstances and I am going to find out just when he would have placed this insurance. [149]

The Court: The witness' testimony on that is all directed to whether or not there was due diligence used in procuring insurance, not on whether or not it was effected, because it never was effected.

Mr. Nesbett: We admit that.

The Court: Particularly in view of plaintiff's

(Testimony of Joseph Sheahan.)

statement that is admitted. It seems it is unnecessary to ask this question.

Mr. Renfrew: Perhaps I misunderstood Your Honor's allowing all this testimony. Certainly Your Honor don't contend this hangs on one man's judgment that he would have done this at that time, but the other man didn't.

The Court: You can, of course, cross-examine him as to the practice of insurance agents, but you are now cross-examining him not on that, but when he considers the insurance here was effected, or whether it was effected at any particular time when it never was in effect.

Mr. Renfrew: Perhaps I can satisfy Your Honor's objection by asking Mr. Sheahan up to the last exhibit you read, which is Exhibit 5, when would you have placed this insurance in effect?

A. When he told me that he wanted six thousand dollars I would have done it, but that is my own opinion.

Q. Then you would have done it?

A. Six thousand dollars, or ten thousand dollars, I would [150] have immediately bound it and sent him a wire.

Q. So that——

Mr. Nesbett: Just a moment——

Q. Go back to the exhibits and tell me on receipt of which exhibit you would have bound the insurance?

A. There is an exhibit here, July 23rd. It is number six, where "we wish to apologize for having

(Testimony of Joseph Sheahan.)

mislaidd your letter of April 17th, giving us the details of the property you wish to have insured. We enclose herewith copy of your letter for reference as we need the following breakdown before we can issue policies. Will you kindly give us this information so we may issue your policies.”

Q. Is that when you would have bound it?

A. No, that is when I think it was bound.

Q. That is when you think it was bound?

A. Yes.

Q. What is the date of that document?

A. July 23, 1948.

Q. And that is when you think the insurance should have gone into effect?

A. That is not when I would have put it into effect. I would have put it into effect when I got his second letter, telling me how much he wanted.

Q. How do you think it was bound then? Do you think there was insurance in this case then?

A. Yes, the man asked for insurance and they say kindly give us this information so we can furnish your policies.

Q. You think that covers actual confirmation?

A. I am not of a legal turn of mind, Mr. Renfrew, and I don't know, but that would be my impression.

Q. Would it make any difference if that letter were written after the fire?

A. Yes, because I think this is the first place they say they actually are going to issue policies.

Q. Then if the fire occurred two or three days

(Testimony of Joseph Sheahan.)

before that it would be your opinion there wasn't any insurance, for whatever it is worth that is your opinion? A. Yes.

Q. Then I take it the letter of the 17th——

A. April 17th?

Q. Yes. That is where you would have gone ahead and written insurance? A. Yes.

Q. Now, would you——

A. I would. Go ahead.

Q. Would you have covered him if you didn't have the authority?

A. No, if I didn't have authority I wouldn't have covered him.

Mr. Renfrew: That is all, Mr. Sheahan. [152]

Further Redirect Examination

By Mr. Nesbett:

Q. If you hadn't had authority to cover him and had wired to your principal and asked for authority to cover him and had received that authority say the day following your request when would you have dated his policy?

A. I would date it the day he ordered it.

Q. A date previous to your receipt of the confirmation? A. No.

The Court: When you say the date he ordered it you don't mean the date you received the letter, but the date of the letter itself?

A. No, I would say—you have stumped me there. Just a moment.

(Testimony of Joseph Sheahan.)

The Court: When a person orders something he orders it when he places the order in the mail.

A. That is right and we would have no knowledge that way of the risk, and that is my personal opinion too, but I would say the man is not covered until we receive the letter, having no knowledge of the risk. It might be a frame sawmill that we wouldn't want to take.

Q. Mr. Sheahan, is it customary in the insurance world to issue policies and make coverage before premiums are paid? A. Oh, yes.

Q. Isn't it true that many premiums are not paid until after [153] a fire occurs?

A. Often times they are not paid before.

Q. The coverage is good nevertheless?

A. Yes, so long as the insured has his policy. There are three ways, the first is to have him voluntarily relinquish the policy and ask for a cancellation, the second is to ask him for his policy for the purpose of cancelling it and the third is to send him notice by mail, giving him five days notice before cancellation becomes effective.

Mr. Nesbitt: That is all, Your Honor.

Mr. Renfrew: No questions.

Mr. Nesbitt: I have another witness, Your Honor, may we have a five minute breather?

The Court: Very well, we will take a recess for ten minutes.

(Short recess.)

(Testimony of Joseph Sheahan.)

Mr. Nesbett: Your Honor, at the time this complaint was drawn up I was under the impression that the two auxiliary buildings were destroyed by fire. I have learned since they were not destroyed by fire. Could I amend the complaint by interlineation?

The Court: Is there any evidence that the auxiliary buildings have not been destroyed?

Mr. Nesbett: Yes.

The Court: All right, then you want to amend to [154] conform to the proof?

Mr. Nesbett: Yes. In Paragraph VII of the first cause of action, line 2, after the words "Paragraph I" I would like to interline and say, "except the two auxiliary buildings."

The Court: You say Paragraph I?

Mr. Nesbett: No, Paragraph VII, after the words "Paragraph I" interline "except the two auxiliary buildings," and the same would apply to Paragraph V of the second cause of action.

The Court: The motion to amend by interlineation is allowed.

Mr. Renfrew: Your Honor, where are you going to interline in Paragraph V?

The Court: After the word "complaint" in the second line.

Mr. Renfrew: I have it now.

The Court: You may proceed.

Mr. Nesbett: Call Mr. Polimeni.

ANTONIO POLIMENI

the plaintiff, being called as a witness in his own behalf, and being first duly sworn, takes the stand and testifies as follows on

Direct Examination

The Court: I notice that the name is spelled in the pleadings as P-o-l-e-m-i-n-i and P-o-l-i-m-e-n-i, which is correct?

Mr. Nesbett: I thought I had it correct.

The Court: Which is the correct spelling?

Mr. Nesbett: I will find something that he wrote on. How did he sign the original of the complaint, Your Honor, the verification?

The Court: It looks like e-m-i.

Deputy Clerk: He signs his name to letters P-o-l-i-m-e-n-i.

The Court: Looks like there is a transposition of e for i. Evidently he signs it P-o-l-i-m-e-n-i.

Mr. Nesbett: Your Honor, Mr. Polimeni, as Mr. Smith said, has a speech impediment, and he is very deaf. I was wondering if I could approach the witness closer than usual, and on occasion it is hard for him to understand the question. He can speak in a dialect that Mary Bistro understands, and I wondered if she could be used as an interpreter.

The Court: Do you object to the use of an interpreter?

Mr. Renfrew: I do, Your Honor, because Mr. Smith, who is very familiar with the circumstances,

(Testimony of Antonio Polimeni.)

and a life long friend says he has no difficulty whatever. He is in the Court Room. Let him do it.

Mr. Nesbett: I don't believe he testified he had no difficulty, said he could eventually get the meaning.

The Court: In view of the objection, I think we should attempt to get along without an interpreter and if it becomes necessary we can use an interpreter.

Mr. Nesbett: Then, Your Honor, can Mr. Smith come up closer and speak to Tony in a loud voice so we can get the idea over to him?

The Court: So long as he will speak in the English language.

(Mr. Smith approaches the witness stand.)

Q. (By Mr. Nesbett): What is your full name, Tony? A. Name Tony Polimeni.

Q. Antonio Polimeni? A. Polimeni, yes.

Q. Where do you live?

A. I live Naknek.

Q. How long have you lived in Alaska?

A. 1931. I been outside three times.

Q. You been outside three times since thirty-one? A. 1938. 1939.

A. All righ, what is your business, Tony?

A. Fisherman.

Q. You have any other business? [157]

A. Cook.

Q. How long have you fished?

A. I fished today thirty-seven years—I got—

(Testimony of Antonio Polimeni.)

Alaska Packers. I been around. I started 1912——

(Reporter's Comment: The witness, Antonio Polimeni, throughout his testimony, on both direct examination and cross-examination, is inaudible and unintelligible. The witness apparently answers the questions at length and with emphasis although only a very few of the sounds he makes are distinguishable as words.)

Q. (By Mr. Nesbett): How long have you fished in Alaska? A. Thirty-seven years.

Q. You lived in Naknek since what date?

A. Forty-two. I live with Billy Regan and take care of kids.

Q. Did you own a restaurant building in South Naknek?

A. (The answer is completely unintelligible.)

Mr. Smith: He misunderstands that.

Q. Did you own a restaurant in South Naknek?

A. No——

Mr. Smith: You have restaurant in South Naknek?

A. Restaurant, yes. I understand different.

Mr. Nesbett: Maybe if you come up here you can do a better job.

(Mr. Smith approaches the witness stand closer.)

Q. (By Mr. Nesbett): What kind of building was that restaurant in?

A. Thirty by thirty and four room upstairs—five rooms. I fix it up.

(Testimony of Antonio Polimeni.)

Q. What year did you buy that building?

A. That building promised to me in forty-two.

The Reporter: Did you say that building promised to me in forty-two?

A. Yes.

Q. When did you get it?

A. I get it up to—Bill Regan pay Charley Watson so much money——

Mr. Smith: He misunderstands.

Q. What year did you get the building for yourself? A. Started about forty-five.

Q. 1945?

A. Bring the lumber there—not what he want——

Q. Ask him what he did to improve it.

Mr. Smith: I want you to tell how much money you spent on the building and what you did?

A. I can't tell. Lot of money. I got about eight people help me—working on the basement—— [159]

Reporter: What does he say?

Mr. Smith: We don't need their names. Tell what else you do. Did you put lumber in it?

A. Yes, from Alaska Packers, two by four, two by twelve, one by twelve. Make shelf. Make partition——

Reporter: Make what?

A. Partition. Have partition, floor and everything.

Mr. Smith: You put anything in it like furniture—beds?

A. Beds. Yes. I got five beds.

(Testimony of Antonio Polimeni.)

Mr. Smith: What else?

A. I got the motor——

Mr. Smith: Did you have chairs? Tell everything.

A. Chairs, yes.

Mr. Smith: Tell everything you put in you can remember?

A. I got stove shipped down.

Mr. Smith: Tell her (indicating the Reporter). She don't know. You put in stove. Tell the other.

A. I got a stove. My stove just—pipe—stove—stovepipe, stove oil——

Mr. Smith: What else you use in restaurant—glasses or dishes?

A. Glasses. Coffee pots—— [160]

Mr. Smith: How big? Have full basement? Half basement? How big?

A. About eighteen by twenty—put two by six sometimes posts. Inside be ten——

Mr. Smith: Inside line it with ten

A. (Answer unintelligible.)

Mr. Smith: Inside he put ten, floored it with two by twelves.

Mr. Smith: You do any work on the well?

A. Yes, I work on the——

Mr. Smith: How big?

A. About thirty feet before get water, about thirty feet—he went down another twenty-seven feet—pipe in the well. Before it was thirty feet.

Q. (By Mr. Nesbett): Who dug the well for you?

(Testimony of Antonio Polimeni.)

A. Al Ruhl and there was an old man named Johnson that killed himself. Raymond Makerfierf——

Mr. Smith: Can he read the names he has written?

Mr. Nesbett: That is all right.

Q. Where did you get the money to do all this work, Tony?

A. Credit at Alaska Packers and some by cash same place.

Q. I mean to do your building from 1945 to 1948?

A. Alaska Packers. [161]

Q. Did you use your fishing money to do it?

A. (Answer unintelligible.)

Reporter: What was his answer?

Mr. Smith: You use your fishing money?

A. Two years, I think. I make money in the fall. I can't run that place.

Q. (By Mr. Nesbett): Ask him how much that thing was worth when he got through with it.

The Court: I think he ought to be instructed if he is not going to speak loud enough he ought to speak into the microphone.

Mr. Smith: He is nervous.

The Court: Maybe you ought to take the microphone into your hands.

Mr. Smith: He asks how much your restaurant worth, everything?

A. About—dollars.

Reporter: What amount?

(Testimony of Antonio Polimeni.)

Mr. Smith: Fourteen thousand dollars, he says.

Q. Ask him if he owned that building?

Mr. Smith: You owned it?

A. Yes, sure, I owned it—what you call it and you buy the stock like a——

Mr. Smith: I don't care. [162]

Mr. Nesbett: That is enough, Mr. Smith.

Mr. Renfrew: Just what did he say? I want to get the answer.

Mr. Smith: He was also explaining that he owned the building but trying to show how much he improved it at the same time.

A. I can't figure out. I got it here.

Q. Did you ask Mr. Coffey to insure it?

A. Sure, I write to him two-three times.

Q. Who wrote the letters for you?

A. The school teacher.

Q. Did you get any information on it?

A. He send the letters to me and I measure the ground up and——

Q. Did you measure the ground up?

A. Sure.

Q. Who did it?

A. A fellow works at the Alaska Packers, I forget the name.

Q. Did Mr. Ruhl help you? A. Yes.

Q. Did you send that information to Mr. Coffey?

A. No, I don't remember—I got——

Mr. Smith: He says he don't remember.

A. ——to go fish for King salmon.

(Testimony of Antonio Polimeni.)

Q. That is all right, Tony, you are getting off the track. [163]

Reporter: What was his answer?

Mr. Nesbett: I don't think it matters.

Mr. Renfrew: I think it does matter.

Mr. Smith: He didn't give an answer that time. He is getting a little confused.

Q. Did you ask anybody else besides Coffey to insure it? A. No.

Mr. Nesbett: This is a bill of particulars filed in the pleadings, Your Honor.

Q. (By Mr. Nesbett): Tony, look at this list of furnishings. That is right. I will read it to you. Did you have six tables in that place?

A. (Answer intelligible.)

Q. Did you have six tables? A. Yes.

Q. Did you have a dining table? A. Yes.

Q. And a china closet? A. Yes.

Q. Cupboard, you know? A. Yes.

Q. How many dressers did you have?

A. Dressers—yes. Beds and dressers.

Q. You had beds? A. Five [164]

Q. Cots? A. Yes.

Q. You had blanket sheets, pillows and cases?

A. Yes, all that I use.

Q. How much did that cook stove cost you?

A. It was \$700, I think \$700—they come down \$500—

Mr. Smith: You want to know what he said?

Mr. Nesbett: Yes.

(Testimony of Antonio Polimeni.)

Mr. Smith: He said the stove was worth \$700, but they marked it down to \$500.

Q. Who marked it down?

A. (Answer unintelligible.)

Mr. Smith: One bookkeeper said \$700 and the one that replaced him said it would be \$400.

Q. Did you have a hot water tank?

A. Yes.

Q. Did you have a water pump?

A. Automatic.

Q. Automatic? A. Yes.

Q. Al Ruhle (interruption).

A. He fixed that.

Q. How much did that pump cost you?

A. I figure everything there they think to connect it cost [165] about \$225, something like——

Q. Did you have a light plant?

A. (Answer unintelligible.)

Mr. Smith: He had a small one. He bought it from another fellow.

Q. How much did it cost you? A. \$350.

Q. \$350? A. Yes.

Q. Did you have any pots and pans to cook with?

A. Cooking plenty——

Q. Did you have dishes?

A. Dishes—kind for sandwiches—everything.

Q. You had many kinds of dishes?

A. Yes.

Q. You had a beer and wine license, didn't you?

A. I got about sixty cases——

(Testimony of Antonio Polimeni.)

Mr. Smith: You don't understand. You have license for beer and wine?

A. Oh, yes.

Q. You had beer and wine in the place when it burned down? A. Yes.

Q. How many cases of beer did you have, do you know? A. About six cases—six-seven.

Q. Six cases? [166] A. Six-seven.

Q. Did you have any wine? A. Yes.

Q. What kind? A. (Unintelligible.)

Mr. Smith: He said they had any kind of wine. The people liked to buy, so he had any kind of wine.

Q. Did you have any groceries in the restaurant?

A. Yes, from the year before.

Q. Did you have a year's supply?

Mr. Smith: Did you have a year ahead?

A. Yes, I think. I like to get a——

Mr. Smith: How long it last?

A. It last for one year and more.

Q. Tony, did this building burn down?

A. Burned down, yes. I was fishing.

Q. You were fishing? A. Salmon.

Q. Did you close the restaurant down?

A. (Unintelligible.)

Mr. Smith: He said that he stopped running it himself and Al Ruhl commenced running it.

Q. When did you leave?

A. I came back the middle of June—we fished the summer for the red salmon, king salmon——

Mr. Smith: He left two weeks before the red

(Testimony of Antonio Polimeni.)

salmon season and he left about the middle of June, is what he said.

Q. Did Al Ruhl run the restaurant while you were gone? A. (Unintelligible.)

Mr. Smith: He told him to take care of the restaurant and he doesn't know whether he run it or not.

Q. Did Al Ruhl go fishing? A. Yes.

Q. Did he close up? A. (Unintelligible.)

Mr. Smith: He said he closed it up. There was no one there.

Q. Did you go back at any time after it closed and before it burned? A. (Unintelligible.)

Mr. Smith: Before restaurant burn, after you go fishing did you come back, look at restaurant again before it burned down? A. I look at it.

Mr. Renfrew: Did he say he did?

(Reporter reads last answer.)

Q. Tony, did it burn down?

A. All to the bottom.

Q. Did you save anything out of it? [168]

A. No. I got insulation in the other room, plenty insulation, burn down too—

Mr. Smith: He was surprised at something he thought it would burn up too.

Mr. Nesbett: I thought he said he was surprised it could burn up too.

Mr. Smith: He did.

Q. Did you have some money in that basement too?

(Testimony of Antonio Polimeni.)

Mr. Smith: Just a moment. Tony, did you have money in the basement?

A. Yes, two thousand dollars.

Q. Where did you hide that money?

A. Down in the paper.

Q. Paper brick? A. Yes.

Q. Rolls of hardface brick? A. Yes.

Q. Did you save any of that money after the fire? A. (Unintelligible.)

Mr. Smith: No, he looked around and everything was out. He means everything was gone. He said the wine was burned up. He didn't see any wine either.

Q. You know about when that restaurant burned down, the date? A. (Unintelligible.)

Mr. Smith: No, he says he was excited and [169] doesn't know when it burned up.

Mr. Smith: You know what month?

A. I think July. Somebody said 22nd, somebody said 20th, must be 20th.

Mr. Smith: He says it must be the 20th.

Mr. Nesbett: I think that is all, Your Honor.

Mr. Renfrew: May I see the exhibits?

Deputy Clerk: Yes.

Cross-Examination

By Mr. Renfrew:

Q. Tony, can you read English?

A. I read but I can't understand everything, a little bit.

(Testimony of Antonio Polimeni.)

Q. You remember when you talked to the school teacher about writing to find out if you could get insurance?

A. I remember writing. I can remember it—17th—

Mr. Smith: That he all right. He is just going into the dates now. He says he can remember, but he can't remember exactly when.

Q. Didn't he say he could remember the 30th of March, or the 17th of April, isn't that what he said? A. (Unintelligible.)

Q. What I want to know is do you remember going to the school teacher and having the school teacher write Mr. Coffey to see if you couldn't get insurance? [170] A. (Unintelligible.)

Mr. Smith: Yes, that is right, but he don't remember the date.

Q. All right, now, did you hear anything from Mr. Coffey? A. He write one time.

Q. One time?

A. One time or two, I can't remember. One time I measure the ground.

Q. You remember receiving any more letters from Mr. Coffey, or just one letter?

Mr. Smith: He has answered that already. He answered one time and another time—two. He just said that previously.

Q. You remember receiving more than two letters from Mr. Coffey? How many altogether?

A. I can't remember—two—

Q. Are you sure?

(Testimony of Antonio Polimeni.)

A. I can't remember——

Q. His answer is I can't remember?

Mr. Smith: He says I can't remember, a little bit more maybe, I don't know.

Q. Can you read that, Tony?

Mr. Smith: You read out loud, Tony.

A. In a reply to your letter March 30 I wish to the—fire—one hundred pound—— [171]

Q. Now, do you understand that?

A. Three hundred dollars. Yes.

Mr. Renfrew: No, I know you understand it (to Mr. Smith), but I don't want him to say something he doesn't understand.

Q. You know what that means?

A. The restaurant——

Q. When you got a letter from Mr. Coffey what did you do with it?

A. I measure the ground. I measure the school house——

Mr. Smith: He is very much confused now.

Q. Are you, Tony? A. (Unintelligible.)

Mr. Smith: It would take a full day to explain each letter to him.

Q. When you got these letters did you get them in the post office? A. Yes.

Q. Is there a post office in South Naknek?

A. South Naknek.

Q. There is a post office there? A. Yes.

Q. Did you go there to get your mail?

A. Somebody bring it. [172]

(Testimony of Antonio Polimeni.)

Q. Did you go to the post office to get these letters?

A. Maybe I get them myself. I can't remember.

Q. What did you do with the letters when you got them? A. I read——

Q. You read it yourself?

A. No, somebody reads.

Q. Somebody reads it to you? A. Yes.

Q. You know who read those letters you got from Mr. Coffey?

A. I can't remember. Maybe——

Mr. Smith: He think Al Ruhl read the letters he got from Mr. Coffey, measuring the ground and the distance to the post office and the school house.

Q. Now, do you remember writing to Mr. Coffey in June, and asking him why he didn't answer you and whether or not you had any insurance?

A. Can't remember.

Q. You don't remember that? Look at this piece of paper here.

Mr. Smith: You read and see if this was letter you send. Maybe you could read the letter out loud and see if you could remember it.

The Court: Is this his signature?

Mr. Smith: Yes.

Q. Did you sign that? A. I signed. [173]

Q. Have you read it now? A. I do.

Q. Read what it says?

A. "Mr. Coffey. I have your letter before concerning—for restaurant and have you——no reply.

(Testimony of Antonio Polimeni.)

I would like you to help from you and——premium of the policy.”

Q. You are not having any trouble reading that, are you? A. Words——.

Q. Read that alright, can't you?

A. I can't think.

Q. You mean you can't understand the words in it? A. (Unintelligible.)

Q. You——

Mr. Nesbett: Let him answer.

Reporter: What was his answer?

Mr. Smith: He can read it, but can't understand it. He says he is not a lawyer.

Mr. Renfrew: I think he is the best lawyer in the court room, that is what I think.

Q. (By Mr. Renfrew): Did you go to the school teacher? A. I went to the school, yes.

Q. Did you go to the school teacher and ask her to write this letter?

Q. Did you say you were writing to Mr. Coffey, wanting to [174] know why he hadn't replied to your letter?

A. Why he didn't write to me before it was too late——.

Mr. Smith: He says before it is too late.

Q. What do you mean before it is too late?

A. It——

Q. You say——

Mr. Nesbett: Let him answer.

Mr. Smith: Don't let him get you excited. Take

(Testimony of Antonio Polimeni.)

your time. A. (Unintelligible.)

Mr. Smith: He said——

Mr. Renfrew: Strike all that.

The Court: I will have to understand him first. I don't know what he said.

Mr. Smith: He says he is not a politician and I have forgotten part of it now.

The Court: In so far as he said anything about his not being a politician it will be stricken.

Mr. Nesbett: Do you think he is, Your Honor?

Mr. Smith: What did you want to ask him?

Q. I wanted to know what he meant by he wanted Mr. Coffey to answer before it was too late.

A. Somebody jealous alright. Where I come from——.

Mr. Smith: He says where he comes from you have to protect your business. The people get jealous. [175]

Mr. Nesbett: Ask what he means by too late?

Q. (By Mr. Renfrew): Just a moment, Tony. You tell us what he said and I will see if it had anything to do with it.

Mr. Smith: He said that was business to have it insured and from where he comes from where people are drunk he has to protect himself.

Q. Did you have a house that burned up down at Egegik? A. Yes.

Q. That burned up? A. Yes.

Q. Insured? A. Yes.

Q. You had an airplane that burned up?

A. Yes.

(Testimony of Antonio Polimeni.)

Q. You think somebody sets your things on fire over there? Is that why you wanted to insure them?

A. I don't know.

Q. When you say you want to hurry up and insure it before it was too late——

Mr. Smith: He says in the type of business——

Mr. Renfrew: He didn't say anything about the type of business. He said the drunks make trouble. That is what he said.

Mr. Smith: Yes. [176]

Mr. Renfrew: Didn't he do that?

Mr. Smith: You talk to him.

A. Maybe make trouble——.

Q. Did you think you were getting insurance for somebody breaking something?

A. No——.

Mr. Smith: He said no.

Mr. Renfrew: He sure did.

Q. How many buildings did you have there, Tony? A. South Naknek?

Q. Yes. A. Restaurant and ——.

Q. You had the restaurant building?

A. Yes.

Q. You had the restaurant building?

A. Yes——.

Q. Did you have any other building?

A. Yes, I got a little——.

Mr. Smith: Before that he said another building, a restaurant and a toilet.

Q. Did you have a building for the light plant?

(Testimony of Antonio Polimeni.)

A. I got the light plant about a hundred feet that way (indicating).

Q. Was the light plant in that building?

A. The building——. [177]

Q. Was the light plant in there?

A. (Unintelligible.)

Mr. Smith: No.

Mr. Renfrew: He didn't say no.

Mr. Nesbett: He doesn't understand. I used the interpreter that he wanted and it worked out alright.

Mr. Renfrew: I am perfectly willing to use the interpreter, but I can understand English.

Q. (By Mr. Renfrew): You want to take five minutes to think this over?

Mr. Smith: You want me to ask——

Mr. Renfrew: I don't want you to ask.

The Court: I think all remarks of counsel should be addressed to the Court.

Mr. Renfrew: I don't like to be interrupted. May I try to proceed in an orderly fashion, and if I get out of bounds the Court can watch me.

The Court: Go ahead.

Q. You had a building you put the light plant in? A. Little building, yes.

Q. Did you have the light plant in it?

A. Yes.

Q. Was the light plant in it when the house burned down? A. I got the porch——. [178]

Q. It was on the porch? A. Yes.

(Testimony of Antonio Polimeni.)

Q. Was it ever in that other little building?

A. Nothing——.

Reporter: What was the answer?

Mr. Smith: Nothing.

Q. You remember when the school teacher wrote this letter? The school teacher wrote this letter too? A. Yes.

Q. This is the letter of April 17th. You remember this letter? A. Yes.

Q. Now, here this says an eight by ten building, fifty feet from main building. This building is used for housing light plant providing electrical power for restaurant and used as a repair shop. Now, you sent that letter to Mr. Coffey, didn't you? You remember that? A. Yes.

Q. Now, was the light plant in there, or wasn't it? A. It was on the porch.

Q. It wasn't in the building then?

A. No, outside on porch.

Q. Do you remember getting a letter from Mr. Coffey after you wrote and wanted to know why you didn't hear from him before it was too late? You remember getting a letter from him after [179] that? A. Yes.

Q. You remember that? A. Yes.

Q. In that letter did he tell you that he didn't get your letter of April 17th? A. 17th——.

Q. You remember receiving a letter from him?

A. 17th——.

Q. When he said he didn't get your letter of the

(Testimony of Antonio Polimeni.)

17th? A. That letter from me the 17th——.

Q. You remember getting a letter telling you he hadn't received your letter, your letter of the 17th, and asking you to go measure again?

A. (Unintelligible.)

Reporter: What is his answer?

Mr. Smith: He got the letter there in the middle of June. He isn't quite sure in his mind.

Mr. Renfrew: Just a minute, Your Honor, the interpreter made a statement just now. It appears to me——

Mr. Smith: Well——

Mr. Renfrew: Just a minute, Bill. It appears the witness does know, he says he got the letter from Mr. Coffey saying he didn't get the letter.

Mr. Nesbett: I am sure he hasn't the faintest idea what is meant.

Mr. Smith: You said did he get the letter and he said yes, and he didn't even know what letter you referred to.

Mr. Renfrew: I thought he understood it very well, at least that is my impression of what he said.

Mr. Nesbett: May I suggest that the interpreter be used and the questions be made short and simple.

The Court: If the witness may misunderstand your questions and therefore make answers that will mislead the jury I think we should use the interpreter.

Mr. Renfrew: I am perfectly willing to use an interpreter, Your Honor, but the only thing Mr.

(Testimony of Antonio Polimeni.)

Smith does instead of interpreting is add. He answers the way he knows the witness should answer.

Mr. Smith: No.

Mr. Renfrew: Well, you wanted him——

Mr. Smith: Certainly I wanted him, but I wanted him honestly——

The Court: I must again warn counsel that they must address all remarks to the Court, or we will have to add to Fund “C” here. Maybe in view of the remarks made about Mr. Smith he should be sworn as a regular interpreter.

Mr. Smith: May I ask a question about it?

Deputy Clerk: Hold up your right hand and be sworn please.

(Mr. Smith holds up right hand.)

Deputy Clerk: You do solemnly swear that you will well and truly interpret the Italian testimony of this witness given in this cause, interpreting the Italian——

(Mr. Smith lowers right hand.)

Deputy Clerk: ——into English and the English into Italian to the utmost of your ability. So help you God.

Mr. Smith: I don't think I should do this. I don't understand Italian.

The Court: No, I don't think you should.

Deputy Clerk: Your Honor, what should I use?

Mr. Renfrew: I don't want to ask any more questions.

(Testimony of Antonio Polimeni.)

Mr. Nesbett: Mr. Smith, would you help me out.

Redirect Examination

By Mr. Nesbett:

Q. I will ask about the Egegik fire.

Mr. Smith: He wants to know about your house in Egegik. You tell him what happened.

A. (Answer unintelligible.)

The Court: Now, now.

Mr. Smith: No, no different thing. Remember you have house in Egegik. What happened to that?

A. Burn up. [182]

Q. Where were you when that happened?

A. Naknek.

Q. You were in Naknek when the house burned in Egegik? A. Yes.

Q. Did you have that house insured with Coffey?

A. Yes.

Q. Did he pay you?

A. Yes, after—three—.

Mr. Smith: He said I write letter three times. Got to wait. I ask him I need the money. I am broke. I want to fix my house.

Q. Was anybody living in that house when it burned? A. Two—and two kids.

Mr. Smith: Two men and two children—kids.

Q. Did you let them live there?

A. (Answer unintelligible.)

Reporter: What was his answer?

Mr. Smith: He said they could stay there. He

(Testimony of Antonio Polimeni.)

said they were supposed to pay rent, but they didn't pay rent nor nothing.

Q. How much did you get from Coffey on that place?

A. Just the kitchen—three or four hundred fifty three—.

Q. How much?

Mr. Smith: Four hundred fifty three dollars and some cents. He just got paid for the kitchen.

Q. Did you have an airplane, Tony?

A. Yes.

Q. Did you buy it? A. I bought it.

Q. For whom? A. For Allen McGregor.

Q. Did you fly it? A. (Unintelligible.)

Mr. Smith: He flew it. He told me he could fly. I don't know. He mean't I don't know if the man could fly or not.

Q. Did you fly with him?

Mr. Renfrew: You ask him if he rode with him.

A. He take me down to Egegik.

Q. Did that airplane burn up?

A. I come back to Naknek—.

Mr. Smith: He took me down to Egegik and back to Naknek and told me he would be back Wednesday or Thursday.

Q. Then what happened?

A. (Answer unintelligible.)

Mr. Smith: He said that it caught fire when he was warming up the engine.

Q. Did it burn up? A. Yes. [184]

(Testimony of Antonio Polimeni.)

Q. Did you have insurance with Coffey on that?

A. Yes——.

Mr. Renfrew: What was his answer?

Mr. Smith: I didn't understand it either.

Mr. Renfrew: Did he say just in time one week?

Mr. Smith: He said he got the insurance check on time.

Mr. Renfrew: I thought he said or——

Mr. Nesbett: Wait a minute.

Mr. Renfrew: ——he would have lost the whole business.

Q. (By Mr. Nesbett): Did Coffey pay you?

A. Yes.

Q. How long did it take?

A. About a month.

Q. How much was it?

A. Twenty-five hundred dollars.

Q. Where were you when the plane burned up?

A. I was at——.

Q. How much did the plane cost?

A. Thirty three hundred——.

Mr. Smith: He said paid thirty three hundred dollars. He says Bill Renfrew knows how much he paid for it.

Mr. Renfrew: Three thousand dollars: You want [185] me to be sworn?

The Court: Again I have to warn counsel.

Mr. Nesbett: That is all, Your Honor.

Mr. Renfrew: Would you interpret some more, please.

(Testimony of Antonio Polimeni.)

Recross-Examination

By Mr. Renfrew:

Q. Ask him when he insured his house in Egegik?

A. Oh, three weeks before, a month before you come here.

Mr. Smith: He said three weeks or a month before I came to Naknek.

Q. Will you ask him the year?

Mr. Smith: What year?

A. (Answer unintelligible.)

Mr. Smith: He said maybe four years ago, but can't remember.

Q. Ask him if it wasn't in January of 1947?

Mr. Smith: What was that again?

Q. Ask him if it wasn't in January, 1947?

Mr. Smith: He says to ask you if it was January, 1947? A. I think wintertime——.

Mr. Smith: He said it was in the winter. He can't remember whether it was January or February, what month. He remembers the house burned on Wednesday. [186]

Q. Ask him when he signed the proof of loss that Mr. Coffey sent to him before he could be paid.

Mr. Smith: When Mr. Coffey send you paper so you could get paid for house, you remember when you signed that paper? A. No.

Mr. Smith: Your house burned down?

A. Yes.

(Testimony of Antonio Polimeni.)

Mr. Smith: You write Mr. Coffey?

A. Yes——.

The Court: I wonder if this could possibly be error.

Mr. Renfrew: Your Honor allowed it.

The Court: The jury is instructed right now not to consider the delay in payment for the loss of the house in Egegik, which has nothing to do with this case.

Mr. Renfrew: We have no further questions then, Your Honor.

Mr. Nesbett: That is all. Defendant rests, Your Honor, or plaintiff rests.

Mr. Renfrew: I wish to make a motion, Your Honor, and I wish to be heard extensively.

The Court: In the absence of the jury?

Mr. Renfrew: Yes, in the absence of the jury.

The Court: You mean it will take sufficient [187] time to warrant excusing the jury for the day?

Mr. Renfrew: I would say it would, Your Honor.

The Court: Very well, the jury is excused until ten o'clock tomorrow morning.

(The jury leaves the room.)

The Court: Does counsel wish to have their arguments reported?

Mr. Renfrew: Not necessary so far as I am concerned at all. It will be confined principally to reading from a brief.

Mr. Nesbett: We will waive.

The Court: You will be excused. [188]

(Testimony of Antonio Polimeni.)

United States of America

Territory of Alaska—ss.

Certificate

I, Lorraine Clarke, the Official Special Court Reporter for the District Court of the United States, Third Division, Territory of Alaska, hereby certify the above and foregoing 188 pages to be a true and correct transcript of the proceedings had in the above-entitled matter in said court at the time and place as set forth.

/s/ LORRAINE CLARKE.

April 20, 1950

The Court: Roll of the jury may be called.

The Clerk: They are all present, Your Honor.

Mr. Renfrew: I wish to call Mrs. McConnell.

GRACE McCONNELL

called as a witness on behalf of the defendant, being duly sworn, testified as follows:

Direct Examination

By Mr. Renfrew:

Q. Will you state your full name, Mrs. McConnell?
A. Grace McConnell.

Q. And you are employed by the Coffey Agency in Anchorage?
A. Yes, I am.

Q. How long have you been so employed?

A. Since 1947.

Q. What is your capacity?

A. Office manager.

(Testimony of Grace McConnell.)

Q. Have you been engaged in general insurance for a period of time?

A. For twenty years.

Q. And what has been your training and what fields, Mrs. McConnell?

A. As underwriter, not as salesman.

Q. And just explain, if you will, the difference between [191] the underwriting parts of your training and the salesman part, what are the different duties—what are your different duties?

A. An underwriter has to pass on the technicalities, the acceptance and rejection of good risks and bad risks.

Q. And where were you employed prior to your connection with the Coffey Agency?

A. In Portland, Oregon, in about four or five offices—branch offices—special agent, local agent and general agent. I was office manager for a general agency for twelve years.

Q. In your capacity as office manager for the Coffey Agency, did you have any connection with the application and the various correspondence that you have heard discussed here in this case with regard to Mr. Polimeni?

A. Yes, I initiated the file by quoting the rate.

Q. I wish to hand you the exhibits which have been offered, I think they go from 1 to 9, are these chronologically correct?

The Clerk: They were the last time I looked at them.

(Testimony of Grace McConnell.)

By Mr. Renfrew:

Q. I hand you Plaintiff's Exhibits 1 through 9, Mrs. McConnell and ask you if you will just briefly glance at Exhibit No. 1 and tell me what that is?

A. That is an inquiry as to rates for fire insurance.

Mr. Renfrew: At this time, Your Honor, I believe [192] we should read these documents to the jury. This is dated South Naknek, Alaska, March 30, 1948, addressed Edward D. Coffey, Anchorage, Alaska. Dear Sir: At this time I am writing concerning an insurance policy covering my new restaurant in South Naknek, Alaska, which houses private living quarters on the second floor and the restaurant on the first floor. Please inform me as to the type or types of policies necessary to insure the building and all fixtures including automatic pump, light plant, dishes, meat saw and food supplies. What form of policy is necessary to cover a seasonal beer and wine supply brought in in the fall valued at \$3,000. Sincerely, Antonio Polimeni.

Now, that letter was received in your office on what date, Mrs. McConnell?

A. On April 6th.

Q. On April 6th. Now, I will ask you if from the information contained in that letter were you able to quote a definite rate?

A. I was able to quote a rate on a building he described.

Q. In that letter you will recall a statement to

(Testimony of Grace McConnell.)

the effect that there was a light plant, would that affect the rate in any way?

A. There is a different rate on a light plant than on a restaurant.

Q. Did you take that into consideration when you made a [193] reply to that letter?

A. The letter of April 9 quotes a rate of \$3 on the building occupied as a restaurant.

Q. I call your attention to Plaintiff's Exhibit 2 and ask you if that was the reply which you sent in connection with the Exhibit 1 which I just read?

A. That is right.

Q. I wish to read this letter to the jury, Your Honor. This is dated April 9th addressed to Mr. Antonio Polimeni, South Naknek, Alaska. Re fire insurance on building occupied as restaurant and dwelling. Dear Mr. Polimeni: In reply to your letter of March 30th, wish to advise that the fire insurance rate on both building and contents is \$3 per one-hundred of insurance for one year. It is necessary to place a specific amount of insurance on the building and a specific amount on equipment and supplies. Beer and wine would be insured under stock. We enclose form which indicates how the insurance is divided. If insurance is ordered we will need to have a description of the location of the property. If the land is unsurveyed so you cannot give us lot and block numbers please advise how far distant your building is from the Post Office or the public school building and also advise the construction and occupancy of any buildings

(Testimony of Grace McConnell.)

within 100 feet of your building. We trust this is the information you desire. Yours very truly, Edward D. Coffey. By, and the By is in blank [194] because this is a carbon copy.

Now I will ask you, Mrs. McConnell, when you sent that letter you requested certain information, would the information furnished you have possibly increased or decreased your rate quotation?

A. Yes, it would have changed it.

Q. Supposing for the purposes of illustration only that when you asked for a description of the buildings within one hundred feet, that Mr. Polimeni had of notified you that there was a gas storage tank house within fifty feet of the building or a powder house with powder supplies within a certain distance would that have increased the rate?

A. Yes, explosives within one hundred feet of frame construction constitute an increase in rate.

Q. Now, I call your attention to Plaintiff's Exhibit No. 3 and ask you if you recognize that as a document received in your office?

A. Yes, it was received April 24th.

Q. And the date of that instrument is April—

A. —the 17th.

Mr. Renfrew: I wish to read this to the jury, Your Honor. This is South Naknek, Alaska, dated April 17, 1948. Addressed Edward D. Coffey, Anchorage, Alaska. Dear Sir: Having received your reply to my inquiry concerning my insurance I am supplying necessary description of the property and equipment. The main restaurant building is

(Testimony of Grace McConnell.)

one thousand feet from the South Naknek Territorial School Building and approximately 300-hundred feet from the Post Office. (1) Main building thirty by thirty. Restaurant—two-story building housing booths, counter, kitchen, pastry room, laundry on the first floor, with five rooms on second floor for living quarters for owner and hired assistants, and basement eighteen by twenty feet providing storage capacity for restaurant supplies and special compartment for automatic pump connected to the well enclosed within the building with descent from kitchen. Attached to kitchen and pertaining to service thereof are kitchen range, hot and cold water tank, and sink. (2) Eight by ten foot building fifty feet from main building. This building is used for housing light plant providing electrical power for restaurant and used as a repair shop. (3) Six by eight foot. Twenty feet from main building. Separate restrooms with shields for entrances. These buildings mentioned have tin roofs and are to be insured en masse for \$6,000. Equipment and supplies: Furniture—five beds complete with all-season bedding, three wardrobe bureaus with clothing of owner and assistant, six chairs, two tables, one sewing machine, and one phonograph (electrical). Fixtures: Washing machine, electric iron, complete line of china and silverware for serving 100 capacity, and bowls, platters and beer and wine glasses. Machinery: Gasoline engine. Automatic water pump, 8 k.w. light plant. The furniture, [196] fixtures, and machinery are to be insured for fifteen hun-

(Testimony of Grace McConnell.)

dred dollars. Stock: Complete line of food supplies for restaurant operation for six months including small amounts of beer and wine. The stock is to be insured for \$2500. I trust this is the complete and necessary description for my insurance application. Thank you, Sincerely, Antonio Polimeni.

Now, when you received that—It is marked Received—I believe you testified, April 24th?

A. Yes.

Q. Now, actually, Mrs. McConnell, what was the status of your office at the time of the receipt of that document?

A. We had just started remodeling the premises and partitions were being torn down. We had to move our desks around to get out of the way of painters or electricians or carpenters, whoever happened to be working, and it was quite chaotic.

Q. Was the application which I have just read mislaid in your office?

A. Yes, it was attached to another file by the girl on the fire insurance desk when she moved all her supplies from one desk to another to get away from the place where they were tearing down the partitions.

Q. Now, I will ask you when that letter subsequently came to light did you have sufficient information with which to write or bind insurance for Mr. Polimeni?

A. According to my training we did not have because I [197] don't write nor do I approve of any

(Testimony of Grace McConnell.)

insurance agent binding any borderline risk promiscuously without complete information.

Q. Did you have the capacity in your office at that time enabling you to have bound that risk without submitting it to a home office, so to speak?

A. No, and I have letters here where we had during the months of April, May and June—letters on other risks—exactly similar in nature where the companies would not take it. In fact, we have one that was cancelled.

Q. Now——

Mr. Nesbett: What was that last?

The Witness: One was cancelled.

Q. (By Mr. Renfrew): In that application, Mrs. McConnell, it states that a light plant is located fifty feet away from a building. Now, you have heard the testimony of Mr. Polimeni and also of Mr. Roof to the effect that the light plant actually was on the back porch, now is a gasoline operated light plant, is that a hazard?

A. It increases the hazard of the house as far as fire insurance.

Q. If you had been able to have written that insurance and the company would have subsequently discovered that the light plant was on the back porch instead of fifty feet away in a building, would they have ever paid the loss? [198]

Mr. Nesbett: I object to that question on the ground that the policy or agreement that would have gone——

(Testimony of Grace McConnell.)

The Court: Very well, the objection is sustained.

Q. (By Mr. Renfrew): I will call your attention to the next exhibit, Mrs. McDonnell, what is that No. 4, please, can you identify that?

A. It is Mr. Polimeni's inquiry as to the disposition of his application.

Q. I wish to read this to the jury, Your Honor. This is dated:

South Naknek, Alaska,
June 1, 1948

Ed. Coffey,
Anchorage, Alaska,

Dear Mr. Coffey:

"I have written you before concerning my insurance for my restaurant and I have received no reply.

"I would like to hear from you immediately and learn the particulars and premium of the policy. Are there any corrections to be made or what needs to be done? Please reply immediately. Thank you."

Sincerely,

ANTONIO POLIMENI.

This is stamped Received by Edward D. Coffey on June 4, 1948.

Q. After you received that letter in your office what [199] did you do, Mrs. McConnell?

A. We attempted to find Mr. Polimeni's letter and we searched as much as we could. It was not found until another girl who took the place—well,

(Testimony of Grace McConnell.)

there was a place on the fire insurance desk and the second girl found it attached to a file.

Q. Did you answer this inquiry of Mr. Polimeni's as to why he hadn't heard from you?

A. I personally didn't answer the letter but the girl on the fire insurance desk did and quoted our letter of April 9th.

Q. And that is Plaintiff's Exhibit No. 5, is it not?

A. Yes.

Mr. Renfrew: I wish to read this to the jury. This is dated:

June 4, 1948

Mr. Antonio Polimeni,
South Naknek, Alaska.

“Re: Fire Insurance on Building occupied as Restaurant and Dwelling.

“We are in receipt of your letter of June 1st in regard to your insurance. We wrote you the following letter, mailed April 9, 1948, but evidently it was lost, so we will quote same:

“‘In reply to your letter of March 30th wish to advise that the fire insurance rate on both building and contents is \$3.00 per \$100 of insurance for one year.

“‘It is necessary to place a specific amount of insurance on the building and a specific amount on equipment and supplies. Beer and wine would be insured under stock. We enclose form which indicates how the insurance is divided.

“‘If insurance is ordered, we will need to have

(Testimony of Grace McConnell.)

a description of the location of the property. If the land is unsurveyed so you cannot give us lot and block numbers, please advise how far distant your building is from the Post Office or the Public School building. Also advise the construction and occupancy of any buildings within 100 feet of your building.'

"We trust that this is the information you desire."

Yours very truly,

EDWARD D. COFFEY,

By /s/

Q. Now, at the time that letter was written were you under the impression that there was only one building?

A. Yes, because at that time we didn't have the application indicating that there were three buildings with which to refer to.

Q. I call your attention to the next exhibit, which is exhibit No. 6 and ask you if you can state what that is?

A. Exhibit No. 6 is the original letter of July 23rd addressed by our office to Mr. Polimeni. [201] Mr. Renfrew: I wish to read this letter to the jury.

July 23, 1948

Mr. Antonio Polimeni
South Naknek, Alaska.

"Re: Fire insurance on building occupied as Restaurant and Dwelling."

(Testimony of Grace McConnell.)

Dear Mr. Polimeni:

“We wish to apologize for having mislaid your letter of April 17th giving us the details of the property you wish to have insured. We enclose herewith copy of your letter for reference as we need the following breakdown before we can issue policies:

“Building No. 1. Please designate a specific amount on the building and a specific amount on the equipment.

“Building No. 2. Specific amount on building.

“Building No. 3. Specific amount on building and specific amount on 8 k.w. light plant.

“We assume the stock of food supplies is contained within the restaurant and no other building.

“Will you kindly give us this information so we may issue your policies.”

Very truly yours,

EDWARD D. COFFEY,

By /s/ M. KASER.

Q. Now, I will ask you whether or not you ever received [202] any reply to your letter of June 4th in reply to Mr. Polimeni's letter of June 1st?

A. No, we didn't.

Q. And did you receive any further correspondence after your letter of July 23rd?

A. Only a letter from Mr. Marchbanks reporting the loss but not giving the date of the fire.

Mr. Renfrew: I wish to read Plaintiff's Ex-

(Testimony of Grace McConnell.)

hibit No. 7 to the jury written on the stationery of Hal M. Marchbanks, United States Commissioner, Kvichak Precinct, Naknek, Alaska.

August 2, 1948.

Mr. Edward D. Coffey
General Insurance
Anchorage, Alaska.

“Re: Fire Insurance on Building occupied as Restaurant and Dwelling.”

“Dear Mr. Coffey:

“I am writing this letter to advise you the building as above described, burned and the policy also burned so it is impossible to supply it with this letter.

“He wishes to put in a claim for the building.

“Kindly advise Mr. Antonio Polimeni of South Naknek, Alaska, of the procedure he is to take.”

Sincerely yours,

/s/ HAL M. MARCHBANKS,

HAL M. MARSHBANKS, by ib
United States Commissioner.

Q. Had you ever issued a policy or attempted to issue a policy, Mrs. McConnell?

A. No, we had not.

Q. In reply to that letter what did you do?

A. We wired Mr. Marchbanks.

Q. That is Plaintiff's Exhibit 8? Which I wish to read to the jury.

(Testimony of Grace McConnell.)

Anchorage, Alaska,
August 5, 1948.

Hal M. Marchbanks
United States Commissioner
Naknek, Alaska

Relet Antonio Polimeni no Insurance in Force as we Have Received no Reply to Our Letters of June Fourth and July Twenty-Third Requesting Value Breakdown on Building and Equipment Policies on Unprotected Restaurants Have to be Ordered From Seattle.

EDWARD D. COFFEY.

This is on a telegraphic form of the Signal Corps of the United States Army.

Q. Did you receive any further correspondence after that? A. No, we didn't.

Q. Did you send any further correspondence after that? A. We wrote to Mr. Polimeni.

Q. And that is Plaintiff's Exhibit No. 9 which I will read to the jury, dated August 5 addressed to Mr. Polimeni. [204]

“Re: Insurance Application.

“We have just received a letter from Mr. Marchbanks stating your new dwelling and restaurant burned. He did not indicate the date of loss. We are very sorry to have to advise you that not having received a reply to our letters of June 4th and July 23rd we could not order the insurance from the Insurance Company in Seattle. We do not have au-

(Testimony of Grace McConnell.)

thority to write unprotected restaurants in our own office, and have to place all applications with Seattle offices. Very few companies will write restaurant occupancies in locations having no fire protection, such as a Volunteer Fire Department. We would have had to place this risk through Lloyds, London, and we cannot submit an application until we have all the required information, which we did not have on your property.

“We are extremely sorry you were unable to reply to our letters so we could have ordered the insurance.”

Yours very truly,

EDWARD D. COFFEY,

By

Q. Now, Mrs. McConnell, on the information given you in the so-called letter of application of April the 17th which your office received but misplaced could you have written the insurance?

A. We could not have bound the insurance in our office without authority from our companies in Seattle. [205]

Q. Did you have sufficient information in that letter with which to submit to your companies in Seattle so that they could have said yes or no or did you need further information?

A. I never submit an application without complete details and particulars as to the risk involved. I don't believe in loosely applying coverage that might eventually become a matter of controversy.

(Testimony of Grace McConnell.)

Q. Whether or not you believe in that theory, Mrs. McConnell, is not of interest to this jury; what I want to know is whether or not you had sufficient information in that application of the 17th day of April to have submitted it to a company asking them to bind or did you have to have additional information in view of the fact that you then discovered there were three buildings?

Mr. Nesbett: Objected, Your Honor, a leading question.

The Court: I don't think it is leading so far. Continue.

Q. (By Mr. Renfrew): —or did you have to have additional information after you had been advised that there were three buildings, one of which housed a light plant?

A. We had to have a breakdown as to the values on each building and the equipment therein to submit the application.

Q. And you have testified that you did not, I believe, receive any reply to your letter of June 4th?

A. Right. [206]

Q. You have heard the testimony of Mr. Sheahan, who testified here that he was employed by the same firm up until sometime in the month of January, 1948, just previous to receiving this application, you heard that testimony?

A. Yes, I did.

Q. I will ask you whether or not you handle insurance from several companies through a general agent in Seattle?

(Testimony of Grace McConnell.)

A. Yes, we do, there are four general agencies in Seattle through whom we write insurance.

Q. Now, so that the jury and the Court will understand the technicalities of that procedure, Mrs. McConnell, would you state whether or not a general agent handles more than one company?

A. Yes, they do.

Q. Would it be possible then for your local agency here to submit an application to a general agent in which that general agent might write the policy in any one of a number of companies?

A. Yes, he might.

Q. Now, in connection with unprotected risks, I will ask you whether or not any general agencies which handled a number of companies for you gave you any specific written instructions in the spring of 1948?

A. Yes, we had one letter already brought into testimony from Cravens, Dargan & Company. [207]

Q. Do you have the letter before you?

A. No, I don't have the original, I have a copy. I can present the original.

Q. You had the original?

A. I am sorry, I guess I left it in the office.

Q. Here it is, I am sorry. I ask you if you can identify that? A. Yes.

Q. Is that a letter received from one of your general agents with regard to unprotected risks?

A. Yes, it is a letter from Cravens, Dargan & Company, dated January 23rd, 1948.

(Testimony of Grace McConnell.)

Mr. Renfrew: I offer this letter in evidence, Your Honor.

Mr. Nesbett: No objection.

The Court: It may be admitted as Defendant's Exhibit "A."

(The document referred to was marked Defendant's Exhibit "A," witness McConnell, and received in evidence.)

DEFENDANT'S EXHIBIT A

Cravens, Dargan & Company
Insurance Managers
60 Sansome Street
San Francisco, California

Aviation & Lloyds Department

W. Robert Anger
Northwest Supervisor
956 Stuart Building
Seattle 1, Washington

January 23, 1948

Edward D. Coffey Agency
Anchorage, Alaska

Gentlemen:

Re: Art Beaudin d/b/a 515 Club

This will confirm our telegram of January 23rd in which we advised that we could not offer any capacity on this risk. The fact that this risk is a cocktail bar and not a night club does not alter the fact that

(Testimony of Grace McConnell.)

the primary occupancy is that of retailing liquor. As you know this type of occupancy has always been considered borderline as far as fire insurance is concerned. At the present time we understand that due to a great drop in business the moral hazard is increasing rapidly. Therefore Mr. Cravens has made a strict ruling that we are to write no night clubs, clubs, bars, or unprotected restaurants.

We are very sorry that we cannot be of service to you in this instance but our underwriting rules cannot be relaxed.

Very truly yours,

CRAVENS, DARGAN &
COMPANY,

By /s/ JOHN F. SOLON.

JFS:meh

[Endorsed]: Filed August 22, 1950.

Mr. Renfrew: I wish to read this letter to the jury. This letter is on the stationery of Cravens, Dargan & Company, Insurance Managers, 60 Sansome Street, San Francisco, California, dated January 23, 1948. Received by Coffey's office January 26, 1948. It is addressed to Edward D. Coffey Agency, Anchorage, Alaska. Gentlemen: [208]

“Re: Art Beaudin d/b/a 515 Club.

“This will confirm our telegram of January 23rd in which we advised that we could not offer any

(Testimony of Grace McConnell.)

capacity on this risk. The fact that this risk is a cocktail bar and not a night club does not alter the fact that the primary occupancy is that of retailing liquor. As you know this type of occupancy has always been considered borderline as far as fire insurance is concerned. At the present time we understand that due to a great drop in business the moral hazard is increasing rapidly. Therefore Mr. Cravens has made a strict ruling that we are to write no night clubs, clubs, bars, or unprotected restaurants.

“We are very sorry that we cannot be of service to you in this instance but our underwriting rules cannot be relaxed.”

Very truly yours,

CRAVEN, DARGAN &
COMPANY,

By /s/ JOHN F. SOLON.

Q. The reference in that letter to “unprotected restaurants” Mrs. McConnell, would that be the class and the type of insurance requested by Mr. Polimeni? A. Yes, it is.

Q. Just so the jury understands clearly what an unprotected risk is, would you explain what an unprotected restaurant would be?

A. An unprotected restaurant is a building in a vicinity [209] which has no fire protection from a regular fire department or a volunteer fire department.

(Testimony of Grace McConnell.)

Q. Such as in a rural district or along a highway or in some hamlet or village?

A. That is right.

The Court: Would it make any difference whether it was a restaurant or any other type of place?

The Witness: Well, there are——

The Court: I mean, would any kind of building or business be an unprotected risk within the meaning of your answer where there was no fire protection?

The Witness: Right.

The Court: The fact that it was a restaurant——

The Witness: ——still doesn't make it protected.

Mr. Renfrew: I believe that is all, Your Honor.

Cross-Examination

By Mr. Nesbett:

Q. Mrs. McConnell, do you have Exhibit "A" that letter from Cravens before you?

A. I have a copy.

Q. I hand you Defendant's Exhibit "A," was that letter written in response to an inquiry from your office about insuring Mr. Beaudin's 515 Club?

A. Yes.

Q. And that inquiry was made by telegraph, was it? [210]

A. I don't know whether the inquiry was; their reply was a wire.

(Testimony of Grace McConnell.)

Q. Their reply? And do you have your file on that complete matter?

A. Not here I haven't.

Q. Do you have it at the office?

A. I think I can find it; this letter was only saved to put in our underwriting file for future reference.

Q. You save your correspondence, don't you?

A. Yes, I do.

Q. You could produce the file on that particular application and risk, couldn't you? A. Yes.

Q. Will you do that?

Mr. Renfrew: I ask the Court what the materiality of an application with reference to a local bar here in Anchorage, what possible materiality could that have in connection with this exhibit or in connection with this case?

The Court: Well, I suppose you had the letter introduced as an exhibit to show the restricted authority of the defendant, is that not correct?

Mr. Renfrew: Yes, and only for that purpose. It specifically states "unprotected restaurants."

The Court: Well, I suppose counsel wants to examine what induced the writing of this particular letter or what [211] representations were made to which this letter is a response. I assume that that is it, I don't know.

Mr. Nesbett: Yes, to inquire, Your Honor. I just want to know what background there was to this reply. I think it is pertinent. It is from one point of view, Your Honor; on the other hand from

(Testimony of Grace McConnell.)

another point of view it isn't. We are relying on the fact that they received the letter, could have done something about it and didn't. Whether they placed it with Cravens, Dargan is not especially important. They could have placed it with someone else. But as long as Mr. Renfrew is going to show that Cravens, Dargan didn't approve this also and we want to know why.

Mr. Renfrew: We would be glad to furnish it. We think, however, that the Court should have the opportunity to examine it before there is any incumbrance of the record. There is nothing in that correspondence excepting an application for a local bar. But the answer is obvious that the company said not only can't we take this risk but we are now absolutely refusing to take any protected restaurants, and that is in this reply.

The Court: The rule is, where you introduce a part of correspondence on the subject the adverse party has the right to have the rest of it and I suppose that what counsel wishes to have produced here is the letter for the purposes of examining what representations were made in it if any that induced the writing of this letter. He has the right to do [212] that although the Court thinks it is not very weighty in view of the fact that it is only one general insurance agency. If you insist on it why I think that it——

Mr. Renfrew: We will submit it.

Mr. Nesbett: Your Honor, I will ask a couple

(Testimony of Grace McConnell.)

of other questions and then maybe I will withdraw the question.

Q. Mrs. McConnell, then, as indicated in that letter, Cravens, Dargan sent a telegram to you with respect to Art Beaudin's 515 Club, didn't they?

A. Yes.

Q. And do you recall the general nature of the contents of that telegram?

A. No, I haven't had occasion to look at it.

Q. Was it in the file that—when you pulled that letter out?

A. No, it was entirely separate, letters which pertain to underwriting rules of an agency—general agency company—are kept currently and this is a letter which we saved to guide us in accepting or refusing requests in the future.

Q. You were in Mr. Coffey's office on January 28th when that letter was written, weren't you?

A. Yes.

Q. And do you recall whether Mr. Coffey was there at that time?

A. My recollection is that he went to Seattle just before [213] January 23rd.

Q. Then, would you, as office manager, be the one to note the contents of that letter and be guided accordingly? A. Yes.

Q. Mr. Sheahan had left the day before, hadn't he?

A. Well, he wasn't in the office. He wasn't off the payroll yet.

(Testimony of Grace McConnell.)

Q. He wasn't in the office in any event. Looking at that letter again, Mrs. McConnell, why do you suppose that Cravens, Dargan sent you a telegram prior to sending that letter?

A. We evidently didn't want the bar or they wouldn't have been in such a hurry to tell us about it.

Q. Isn't it quite possible that you telegraphed Cravens and Dargan so that you could get a risk covering Art Beaudin and his bar?

A. Not likely.

Q. It is possible that you received a telegraphic response? A. It is possible.

Q. Have you ever been in business for yourself, Mrs. McConnell? A. No.

Q. You have always worked for someone else?

A. Yes.

Q. Under the direction of an agent such as Mr. Coffey? A. That is right. [214]

Q. What do you mean by the technicalities of whether a risk is good or a risk is bad? You state that an underwriter has the duty of doing that sort of thing. A. That is right.

Q. Would you explain?

A. We have to follow certain instructions from the insurance companies as to the acceptability of risks and that applies to fire insurance and all the lines. One company will have one set of underwriting rules and another company will have others. Some companies are more lenient and some are more strict. It is up to the underwriter to abide

(Testimony of Grace McConnell.)

by the instructions of the insurance companies or the general agencies representing the companies.

Q. Would you say that your position under Mr. Coffey is that of underwriter, Mrs. McConnell?

A. The office manager accepts the duties of an underwriter.

Q. Then actually you are a sort of assistant underwriter; Mr. Coffey in this situation I guess would be analogous to that of the underwriter?

A. I didn't consider the owner of a business that of an underwriter; he is more of a salesman.

Q. Is that true of Mr. Coffey's position that it is analogous to that of underwriter?

A. No, mine.

Q. When you received Mr. Polimeni's letter of April 9th, [215] an inquiry with respect to rates, that is Plaintiff's Exhibit No. 1, you immediately answered it, didn't you? A. Yes.

Q. When was that letter received, do you know?

A. There is a received date on the original.

Q. April 6th, I believe.

The Court: Do you refer to the Plaintiff's Exhibit letter of April 9th, now, that is an obvious mistake?

Mr. Nesbett: I am referring to Plaintiff's Exhibit 1, Plaintiff's letter of March 30th.

Mr. Renfrew: I still suggest that they should be handed to her.

The Court: I think we will recess at this point. Court will be in recess until two p.m.

(Testimony of Grace McConnell.)

(Whereupon, at twelve noon the trial was recessed until two p.m. the same day.) [216]

Afternoon Session

Mr. Nesbett: Your Honor, before the witness resumes the stand I think Your Honor was going to consider as to whether or not we have a contract here. You would like to do it as early in the case as possible so as not to prejudice the defendant or prolong the trial and causing them to bring in additional testimony.

The Court: I didn't hear the first part of your statement?

Mr. Nesbett: Assuming Your Honor would reconsider your ruling on whether or not there was a contract in this case you would want to do it as early as possible in order not to prolong the trial or prejudice the defendants. This is what I learned at noon——

Mr. Renfrew: Just a moment. I have understood that there wasn't any question about reconsideration of that ruling and I object to any argument in the presence of the Jury on that point at all.

The Court: Well, I certainly didn't anticipate that it was an open question any more or would be considered an open question, however if you want to bring something to the attention of the Court that you think should be brought to the attention of the Court—is it something however that may properly be stated before the Jury?

(Testimony of Grace McConnell.)

Mr. Nesbett: I think I can state it in such a way, [217] Your Honor, that it certainly won't prejudice the case at all on the defendant's side of the case, but in discussing certain phases of the Egigik fire with Mr. Polimeni during the lunch hour I have uncovered testimony which I think will cause Your Honor to reconsider his ruling on the question of contract and I don't know whether Your Honor would want to have it come in now or when but I would like to put it before Your Honor.

The Court: If you want to state the substance of that evidence it ought to be done in the absence of the Jury. The jury may retire until recalled. Retire to the jury room until recalled.

(Reporter excused during arguments of counsel.)

Redirect Examination

By Mr. Renfrew:

Q. Mrs. McConnell, you have identified the various exhibits this morning, I refer now to Plaintiff's No. 2, which is the letter of April the 9th responding to the inquiry of March 30th made by Mr. Polimeni. In the second paragraph of that letter we say, "We enclose a form." I hand you this paper and ask you if that is the form that you enclosed to Mr. Polimeni when you sent the letter of April 9th?

A. This is the form. They are all the Form 78.

(Testimony of Grace McConnell.)

Q. It is a printed form, is it? A. Yes.

Q. And that is identical with the one sent him?

A. Yes, sir. [218]

Mr. Renfrew: We offer that in evidence, Your Honor.

Mr. Nesbett: There is no objection.

The Court: It may be admitted as Defendant's Exhibit "B."

(The document referred to was marked Defendant's Exhibit "B," witness McConnell, and received in evidence.)

BUILDING, EQUIPMENT AND STOCK FORM

issued to and forming part of Policy No. _____ of the _____

City or Town and State _____, Dated _____

This policy covers the following described property, all situated _____

Designate Street Number or Lot and Block Number or Township, Section, Range and County _____ State of _____

1. **BUILDING:** ON the _____ story _____ roof _____ CONSTRUCTION _____ BUILDING _____ while occupied as _____ DESCRIBE OCCUPANCY _____
2. **EQUIPMENT:** ON EQUIPMENT, pertaining to Insured's occupancy as _____ DESCRIBE OCCUPANCY _____ all only while contained in, on or attached to the above described building. *Sept. 1948 B*
3. **STOCK:** ON STOCK, consisting principally of _____ DESCRIBE _____ *Polimeri*
4. **ON _____ DESCRIBE _____**
5. **ON _____ DESCRIBE _____** *vs. Plaintiff*

6. Insurance attaches hereunder only to those items for which an amount is shown in the space provided therefor and not exceeding said amount for such item(s). For definition of terms "Building," "Equipment," "Stock," see paragraph 7 below; for extensions and exclusions see paragraph Nos. 8, 9 and 10 below.

7. DEFINITION OF TERMS:

(I) **BUILDING:** Building or structure in its entirety, including all fixtures and machinery used for the service of the building itself, provided fixtures and machinery are contained in or attached to and constitute a part of the building; additions in contact therewith; platforms, chutes, conveyors, bridges, trestles, canopies, gangways, and similar exterior structures attached thereto and located on the above described premises, provided, if the same connect with any other building or structure owned by the named Insured, then this insurance shall cover only such portion of the same as is on the above described premises as lies between the building covered under this policy and a point midway between it and such other building structure; also (a) awnings, signs, door and window shades and screens, storm doors and storm windows; (b) cleaning and fire fighting apparatus; (c) janitors' supplies, tools and implements; (d) materials and supplies intended for use in construction, alterations or repairs of the building. Provided, however, that property described in (a), (b), (c) and (d) immediately above must be, at the time of any loss, (1) the property of the named Insured who is the owner of the building; and (2) used for the maintenance or service of the building; and (3) contained in or attached to the building; (4) not specifically covered under an item other than the "Building" item of this or any other policy.

(II) **EQUIPMENT:** Equipment and personal property of every description, and, provided the described building is not owned by the named Insured, "Tenant's Improvements and Betterments" installed or paid for by the named Insured; but excluding, (1) bullion, manuscripts, and machine tools or foundry patterns, (2) property (whether covered under this policy or not) included within the description or definition of "Stock," (3) property for sale, and (4) property covered under the "Building" item of this or any other policy.

(III) **STOCK:** Stock of goods, wares and merchandise of every description, manufactured, unmanufactured, or in process of manufacture; materials and supplies which enter into the manufacture, packing, handling, shipping and sale of same; advertising material; all being the property of the named Insured, or sold but not removed (it being understood that the actual cash value of stock sold but not removed shall be the Insured's selling price); and the Insured's interest in materials, labor and charges furnished, performed on or incurred in connection with the property of others.

8. **EXTENSION CLAUSE:** Personal property of the kind and nature covered under any item hereof shall be covered under the respective (a) while in, on, or under sidewalks, streets, platforms, alleyways or open spaces, provided such property is located within 50 feet of the described building; and (b) while in or on cars and vehicles within 300 feet of the described "Building," and (c) while in or on barges and scows or other vessels within 100 feet of the described premises; provided such property is not covered by marine, inland marine or transportation insurance of any kind.

9. **TRUST AND COMMISSION CLAUSE:** To the extent that the named Insured shall be liable by law for loss thereto or shall prior to have specifically assumed liability therefor, any item of this policy covering on personal property shall also cover property of the kind and nature described in such item, at the location(s) herein indicated, held in trust, or on consignment or commission, or on joint account with others, or left for repair or repairs.

10. **EXCLUSION CLAUSE:** In addition to property expressly excluded from coverage by any provision of this form or other endorsement attached to this policy, the following are not covered under any item of this policy and are to be excluded in the application of any "Average Clause" or "Distribution Clause": land values, gardens, trees, lawns, plants, shrubbery, accounts, bills, currency, deeds, evidences of debt, money, securities, rafts, boats, motor vehicles,

In case of loss, the Insured to file a substantiated (transportation, or the cost of such, from San Francisco and/or Point San Francisco and at the location of the loss and return, in one duplicate, if one be sent, for all Companies concerned

11. Loss, if any, under each item of this policy shall be adjusted with and payable to the Insured specifically named herein unless otherwise agreed in writing by this Company.

12. Loss, if any, under item(s) _____ subject to all the terms and conditions of this policy, and to the written agreement, if any, between this Insured and the following named Payee, is payable to _____

Business address is _____

13. **AVERAGE CLAUSE (THIS CLAUSE VOID UNLESS PERCENTAGE IS INSERTED):** In event of loss to property described by any item of this policy as to which item a percentage figure is inserted in this clause, this Company shall be liable for no greater proportion than such loss than the amount of insurance specified in such item bears to the following percentage of the actual value of the property described in such item at the time of loss, nor for more than the proportion which the amount of insurance specified in such item bears to the total insurance on the property insured in such item at the time of loss:

_____ per cent (_____ %) applying to Item No. _____
_____ per cent (_____ %) applying to Item No. _____
_____ per cent (_____ %) applying to Item No. _____

If this policy be divided into two or more items, the foregoing conditions shall apply to each item separately.

THE PROVISIONS PRINTED ON THE BACK OF THIS FORM ARE HEREBY REFERRED TO AND MADE A PART HEREOF.



PROVISIONS REFERRED TO IN AND MADE PART OF THIS FORM (No. 78)

14. WAIVER OF INVENTORY AND APPRAISEMENT CLAUSE: If any item of this policy is subject to the conditions of the Average Clause (Paragraph 13 hereof), it is also provided that when an aggregate claim for any loss to the property described in any such item of this policy is less than Five Thousand Dollars (\$5,000.00) and less than two per cent (2%) of the total amount of insurance upon the property described in such item at the time such loss occurs, it shall not be necessary for the Insured to make a special inventory or appraisal of the undamaged property. Nothing herein contained shall operate to waive the application of the Average Clause to any such loss.

If this policy be divided into two or more items, the foregoing conditions shall apply to each item separately.

15. EXCESS INSURANCE LIMITATION CLAUSE: No item of this policy shall attach to or become insurance upon any property, included in the description of such item, which at the time of any loss

(a) Is more specifically described and covered under another item of this policy, or under any other policy carried by or in the name of the Insured named herein, or

(b) Being the property of others is covered by insurance carried by or in the name of others than the Insured named herein,

the liability of insurance described under (a) or (b) has first been exhausted, and shall then cover only the excess of value of such property over the amount payable under such other insurance, whether collectible or not. This clause shall not be applicable to property of others for the loss of which the Insured named herein is liable by law or has prior to any loss specifically assumed liability.

16. TENANT'S IMPROVEMENTS AND BETTERMENTS CLAUSE: "Tenant's Improvements and Betterments" (subject to the provisions of the paragraph hereof entitled "Equipment") are covered as property of the named Insured under the "Equipment" item of this policy, regardless of whether or not the same have or will become a permanent or integral part of the building (a) or the property of the building owner or lessor. The amount of loss on such "Tenant's Improvements and Betterments" shall be determined on the basis of the actual cash value thereof at the time of loss. In the event of any limitation upon the interest of the Insured therein resulting from any lease or rental agreement affecting the same, the insurance covering such "Tenant's Improvements and Betterments" shall not be prejudiced, nor shall the amount recoverable for loss thereon be diminished, because of any insurance covering on the same issued in the name of the owner of said building(s) or of others than the Insured named in this policy. This policy, however, shall not contribute to the payment of any loss to "Tenant's Improvements and Betterments" covered under any policy or policies issued in the name of the owner of said building(s) or of others than the Insured named in this policy.

17. CONSEQUENTIAL DAMAGE ASSUMPTION CLAUSE: (To apply only if stock of merchandise, provisions or supplies in cold storage, which stock is subject to damage through change of temperature, are covered hereunder.) This Company (subject to the terms of this policy) shall be liable for consequential loss to stock of merchandise, provisions and supplies in cold storage covered hereunder caused by change of temperature resulting from total or partial destruction by any peril insured against in this policy, of refrigerating or cooling apparatus, containers or supply pipes thereof, unless such loss is specifically excluded as to any such peril by express provision of any form, rider or endorsement attached to this policy.

The total liability for loss caused by any peril insured against in this policy and by such consequential loss, either separately or together, shall in no case exceed the total amount of this policy in effect at the time of loss. If there is other insurance upon the property damaged covering the perils, or any thereof, which are insured against in this policy, this Company shall be liable only for such proportion of any consequential loss as the amount hereby covered bears to the whole amount of insurance thereon whether such other insurance covers against consequential loss or not.

18. BREACH OF WARRANTY CLAUSE: If a breach of any warranty or condition contained in any rider attached to or made a part of this policy shall occur, which breach by the terms of such warranty or condition shall operate to suspend or avoid this insurance, it is agreed that such suspension or avoidance due to such breach, shall be effective only during the continuance of such breach and then only as to the building, fire division, contents therein, or other separate location to which such warranty or condition has reference and in respect of which such breach occurs.

19. SUBROGATION WAIVER CLAUSE: This insurance shall not be prejudiced by agreement made by the named Insured releasing or settling this Company's right of subrogation against third parties responsible for the loss, under the following circumstances only:

(I) If made before loss has occurred, such agreement may run in favor of any third party;

(II) If made after loss has occurred, such agreement may run only in favor of a third party falling within one of the following categories at the time of loss:

(a) A third party insured under this policy; or

(b) A corporation, firm, or entity (1) owned or controlled by the named Insured or in which the named Insured owns capital stock or other proprietary interest, or (2) owning or controlling the named Insured or owning or controlling capital stock or other proprietary interest in the named Insured;

(III) Whether made before or after loss has occurred, such agreement must include a release or waiver of the entire right of recovery of the named Insured against such third party.

20. AUTOMATIC REINSTATEMENT CLAUSES: (a) Applying to losses not exceeding One Hundred Dollars (\$100.00) under this policy, the amount of insurance hereunder involved in a loss payment of not more than One Hundred Dollars (\$100.00) for this policy shall be automatically reinstated.

(b) Applying to losses in excess of One Hundred Dollars (\$100.00) under this policy: In the event of any loss payment under this policy in excess of One Hundred Dollars (\$100.00) the amount paid shall be deemed reinstated and this policy automatically reinstated to the full amount in force immediately preceding said loss, provided that the policy shall be endorsed to that effect within 30 days after the payment of loss, and the Insured shall pay to the Company the pro rata premium for the unexpired time from the date of said loss to the expiration of this policy, at the rate in force at the time of said reinstatement. This clause shall apply to each loss separately.

21. VACANCY—UNOCCUPANCY—CESSATION OF OPERATIONS CLAUSE: Unless otherwise specified by endorsement added hereto: (a) If the subject of this insurance be a manufacturing, mill, or mining plant, permission is granted to remain vacant or unoccupied or to shut down and cease operations, for a period of not to exceed sixty (60) consecutive days at any one time; or (b) If the subject of insurance be a cannery, fruit, nut or vegetable packing or processing plant, fish reduction plant, hop kiln, rice drier, beet sugar factory, cotton gin, cotton compress or cotton seed oil mill, permission is granted to remain vacant or unoccupied for a period of not to exceed sixty (60) consecutive days at any one time, or to shut down and cease operations (but not to be vacant) for a period of not to exceed ten (10) months at any one time; (c) Except as otherwise provided in (a) and (b) immediately above, permission is granted to remain vacant or unoccupied without limit of time. Nothing herein contained shall be construed to abrogate or modify any provision or warranty of this policy requiring (1) the maintenance of watchman service; (2) the maintenance of all fire extinguishing appliances and apparatus including sprinkler system, and water supply therefor, and fire detecting systems, in complete working order; nor shall it extend the term of this policy.

22. PERMITS AND AGREEMENTS CLAUSE: Permission granted: (a) For such use of the premises as is usual or incidental to the business conducted therein and for existing and increased hazards and for change in use or occupancy except as to any specific hazard, use, or occupancy prohibited by the express terms of this policy or by any endorsement thereto; (b) To keep and use all articles and materials usual and incidental to the business, in such quantities as the exigencies of the business require; (c) For the building(s) to be in course of construction, alteration or repair, without limit of time but without extending the term of this policy, and to build additions thereto, and this policy under its respective item(s) shall cover such building(s) or in such additions in contact with such building(s); but if any building herein described is protected by automatic sprinklers, this permit shall not be held to include the reconstruction or the enlargement of any building so protected, without the consent of this Company in writing. This permit does not waive or modify any of the terms or conditions of the Automatic Sprinkler Clause (if any) attached to this policy.

This insurance shall not be prejudiced: (1) By any act or neglect of the owner of the building if the Insured is not the owner thereof, or by any act or neglect of any occupant of the building (other than the named Insured), when such act or neglect of the owner or occupant is not within the control of the named Insured; (2) By failure of the named Insured to comply with any warranty or condition contained in any form, rider or endorsement attached to this policy with regard to any portion of the premises over which the named Insured has no control; nor (3) shall any insurance hereunder be voided or be prejudiced by any error in stating the name, number, street or location of such building(s).

23. ELECTRICAL APPARATUS CLAUSE: If electrical appliances or devices (including wiring) are covered under this policy, this Company shall not be liable for any electrical injury or disturbance to the said electrical appliances or devices (including wiring) caused by electrical currents artificially generated unless fire ensues, and if fire does ensue this Company shall be liable only for its proportion of loss caused by such ensuing

(Testimony of Grace McConnell.)

Q. (By Mr. Renfrew): I ask you whether or not that form was ever returned executed?

A. No, sir.

Q. Was it ever returned at all?

A. No, sir.

Q. In the letter of April 9th, being Plaintiff's Exhibit 2, you stated, "It is necessary to place a specific amount of insurance on the building and a specific amount on equipment and supplies; beer and wine would be insured under stock. We enclose form which indicates how the insurance is divided." Now, in that form does that set forth the place to set out the separate buildings?

A. No, this is for one building and the equipment and the stock in one building.

Q. Now, I will ask you, of course, when you sent that you had only the inquiry letter of March 30th?

A. Yes, sir. [219]

Q. Now, is there any exclusions pointed out or are there any exclusions pointed out on that form which you forwarded?

A. Yes, sir, there are standard exclusions in all of our policies.

Q. And where are they located on the form?

A. It would be paragraph 10, Exclusion Clause.

Mr. Renfrew: Will counsel stipulate to the waiving of the reading of this entire exhibit at this time?

Mr. Nesbett: Yes, I will.

Mr. Renfrew: I wish to read, Your Honor, just the exclusion clause under paragraph 10:

(Testimony of Grace McConnell.)

“In addition to property expressly excluded from coverage by any provision of this form or other endorsement attached to this policy, the following are not covered under any item under this policy and are to be excluded in the application of any average clause or distribution clause * * *” And among other things listed such as land values, gardens, trees, lawns, plants, shrubbery, accounts, bills, is the word “currency and money.” Now, I will ask you, Mrs. McConnell, would it have been possible for you to insure the currency which Mr. Polimeni has alleged that he lost that was buried in his basement?

A. Not under a fire insurance policy.

Q. Not under a fire insurance policy?

A. No, sir. [220]

Q. Now, you testified this morning that on the 23rd of January, a letter bearing that date at least, from Cravens, Dargan & Company advised you that you could no longer write unprotected restaurants?

A. Yes, sir.

Q. How many companies do Cravens, Dargan represent that you write through?

A. Two, one American company and Lloyds.

Q. You heard Joe Sheahan testify that he would have bound this risk for some \$1500 or \$2500, whichever he could have and then would have submitted the balance to Lloyds, you heard him testify to that?

A. Yes, sir.

Q. Is the Lloyds Company that Cravens and

(Testimony of Grace McConnell.)

Dargan represent the same Lloyds and the only Lloyds that there is insofar as the testimony of Mr. Sheahan is concerned, is that just one company?

A. That is one Lloyds connection; there is another Lloyds connection through Sweet & Crawford.

Q. Did you have outlets through both Sweet & Crawford and Cravens, Dargan?

A. Yes, we did.

Q. Now, Sweet & Crawford at any time ever limit your risk on unprotected restaurants?

A. We had an application from Nanana for a restaurant. [221] Now, I don't know if Nanana has a volunteer fire department.

Mr. Nesbett: I object to this answer as not being responsive—"Did they ever limit * * *?" It would have to be, Your Honor, a general limitation on their ability to either bind or get permission to cover unprotected risk, I think that should be the tone of the answer rather than state some particular instance in Nanana.

The Court: I have ruled time and again that the answer that is not responsive is not available to anyone except the counsel doing the questioning and if you have to object you have to object on some other grounds otherwise the Court can't pay any attention to it, on such grounds as incompetent.

Mr. Nesbett: I will object, incompetent, irrelevant and not material, not responsive to the question put.

The Court: Overruled.

(Testimony of Grace McConnell.)

Mr. Renfrew: You may answer.

A. In Nanana a man owned a restaurant and they asked us to insure this restaurant and with the application we wrote to Sweet & Crawford and asked them if they could take the risk and they replied they could not in Lloyds and that——

Q. When was that?

A. Their letter is dated June 9th.

Q. June 9th? A. 1948. [222]

Q. 1948, that would be then two other companies or would that be one of them? A. Two.

Q. Two other companies?

A. Lloyds and Sun.

Q. You have another outlet through another agent, Frank Burns, I believe, is that correct?

A. Yes, sir.

Q. Have you had any experience with Frank Burns in the spring of 1948 limiting you or excluding unprotected risks completely?

A. Yes, sir, this risk in Nanana had been insured in three years in Rhode Island, which was one of Frank Burns' companies.

Q. Was this risk in Nanana a restaurant?

A. Yes, sir.

Q. All right, go ahead.

A. And we wrote to Frank Burns and asked if they could renew this risk.

Q. When did it expire?

A. In February, 1948.

Q. Yes.

A. The owner of the restaurant did not write

(Testimony of Grace McConnell.)

for the renewal until May 1st. On May 21st Frank Burns responded "We are sorry to advise that we will be unable to handle this [223] in our companies. Our loss experience has been poor on restaurants and as this is unprotected would be that much worse. If you wish we will be happy to attempt to broker it for you. It is very doubtful that we could place this in American companies and it is likely it would have to be placed with Lloyds." Frank Burns has five companies.

Q. Handles five companies? A. Yes.

Q. And you had already, I believe, according to your testimony, had advices from both of your Lloyds outlets that they wouldn't write unprotected restaurants? A. Yes, sir.

Q. Now, then, as a total how many companies were you advised of in the spring of 1948 that you could not write these unprotected risks on, how many different companies?

A. On the basis of this testimony, seven American companies and two Lloyds outlets. There were other American companies, too.

Q. What do you mean by "There were other American companies"? You mean there were other American companies which you have received advices from that you haven't testified concerning?

A. Yes, sir, Golden Rule.

Q. What is the circumstances surrounding that outlet for your coverage on unprotected risks?

The Court: What is the name of that one?

(Testimony of Grace McConnell.)

The Witness: Golden Rule, General Agents. It is the Nanana risk.

Q. (By Mr. Renfrew): Do I understand from your testimony that you attempted then to place the Nanana risk with Gould & Gould?

A. Yes, sir.

Q. And what was their reply?

A. "Your favor of the 25th on the above. We can undoubtedly place this business with Lloyds. I know the risk and I know the assurance. Advise us of the details and also tell us if it is to be written for one year or three. If three years it is two and one-half times the annual premium as Nanana is not given a credit for protection by the Pacific Board."

Q. Was the risk subsequently written through Gould?

A. Yes, sir, in July, not one of the companies we represented but in a company they brokered with.

Q. No company that you had any outlet with at all, is that your testimony? A. Yes, sir.

Q. And how long had you been trying to place that, did you say since February? A. May.

Q. Since May? A. Yes, sir. [225]

Q. And it was finally——

A. ——consumated in, I believe it was, July 22nd.

Q. And do you have a copy of the policy?

A. Yes, sir.

Q. What is the date—the date limits on the policy? A. It was effective July 22, 1948.

(Testimony of Grace McConnell.)

Q. July 22, 1948? A. Yes, sir.

Q. Then the date of the coverage dated from the time you were able to effect it rather than from the date of application of the person to get the coverage?

A. We received the policy on August 4th.

Q. I think you misunderstood me, you stated that that coverage had previously been written by some company that you handled?

A. Rhode Island.

Q. And am I correct in stating that that was a company that you had handled?

A. We represented. It was too old a risk for me to determine if we had had it in our office.

Q. When had the policy expired?

A. In February, 1948.

Q. And had you attempted to renew it?

A. We did not have a request to renew it until May.

Q. Did you attempt to renew it? [225A]

A. Yes.

Q. In May? A. Yes, sir.

Q. And you were unable to do so?

A. Frank Burns said they couldn't handle it.

Q. Now, do I understand your testimony to be that you finally got an outside broker to place it in a company which you had nothing to do with?

A. Well, if you would call Gould & Gould a broker. They are general agents. They brokered it to a company they did not represent. They had to go out on the street, so to speak, to get it covered.

(Testimony of Grace McConnell.)

Q. Now, what I want to know, is the policy dated back in May first when the man up at Nenana said "I want you to get some insurance" or was it dated when Gould & Gould were able to find somebody who would insure it?

A. It was dated when Gould & Gould could find somebody to insure it.

Q. Were you able to get the information Mr. Nesbett requested before lunch, that is, the file on the Beaudin application? A. Yes, sir.

Q. Do you have that there now?

A. Yes, sir.

Mr. Renfrew: That is all, Your Honor. [226]

Recross-Examination

By Mr. Nesbett:

Q. What was wrong with that Nenana restaurant that they all shied away from it?

A. It was the nature.

Q. What was the nature of it?

A. Unprotected restaurants are considered undesirable business.

Q. What was peculiar about this Nenana restaurant?—

A. It was no more peculiar—

Q. —that caused everyone to shy away from it?

A. Because they weren't writing unprotected restaurants.

Q. You mean it didn't make any difference

(Testimony of Grace McConnell.)

whether it was the Nenana or any unprotected restaurant? A. That is right.

Q. They were all shying away from it?

A. That is right.

Q. They finally got a policy on July 22nd?

A. Yes, sir.

Q. You knew about all the trouble with the Nenana restaurant, you were at the office all the time? A. Yes, sir.

Q. What caused you to write Mr. Polimeni and ask him to send this information?

A. Because we could find a—— [227]

Q. You used the word “issue”?

A. The word issue may be used loosely, as to whether you actually write the policy——

Q. What caused you on August 4th to cause you to write to Polimeni and say “We are so sorry about all this. We have to go to Seattle to write unprotected restaurants.”

A. All this correspondence is from Seattle.

Q. “Our Seattle office” you said, didn’t you, in your letter of August 4th—5th?

Mr. Renfrew: Show her the letter.

The Court: Look at Exhibit No. 9, do you have it there?

The Witness: No.

The Court: You are familiar with the letter?

The Witness: Yes.

Q. (By Mr. Nesbett): “We have to place all applications with Seattle offices——”

A. Right.

(Testimony of Grace McConnell.)

Q. "——and issue policies on July 23rd."

A. Yes, sir, using the word "issue" can be used very loosely as to whether you write the policy or whether you order the policy.

Q. As a matter of fact, on July 23rd when you discovered Tony's letter there in the office you could have wired your Seattle office describing the risk and asked for coverage, [228] couldn't you?

A. Yes. But we still did not have the breakdown.

Q. You could have wired though and given them the information and asked for insurance?

A. We don't submit until we have the full particulars. You must remember on the Nenana risk we had the full particulars. We already had an existing policy.

Q. To answer my question, you could have wired on July 23rd when you discovered Tony's letter, couldn't you? A. No, sir.

Mr. Renfrew: I object to that question as it is susceptible of only one answer and that would be that she obviously could have wired because she has the physical capabilities of doing it and in order to answer that question under oath, Your Honor, she has to say "yes," but you can't answer that question and say "yes" without a qualification. Counsel should state what he means by "could she"?

The Court: I assumed that what counsel had in mind is what his previous questions implied, although the witness may not necessarily understand it that way, and for that reason I think the question should be a little more definite.

(Testimony of Grace McConnell.)

Q. (By Mr. Nesbett): Mrs. McConnell, you said, did you, that it was not your policy to submit until you had all the details?

A. Yes, sir. [229]

Q. Is that a policy laid down by Mr. Coffey?

A. I don't know that he has said that in so many words; it was my training.

Q. Is that your policy, then?

A. Yes, sir.

Q. As a matter of fact, though you could have wired on July 23rd giving the details of the risk and stating that although there were three buildings the definite allocation of \$6,000 between them would have to be determined later and gotten the ball rolling, couldn't you?

A. That is a matter of judgment.

Q. You could have done that?

Mr. Renfrew: You mean physically again? I still make the same objection.

The Court: I think it is clear enough now, because the other question that immediately preceded it, as to what counsel means and I think the witness understands what he means and the objection is overruled.

Q. (By Mr. Nesbett): You could have sent such a wire, couldn't you, when you received Tony's letter?

A. I could have sent a wire; that doesn't mean coverage.

Q. No, you could have asked for coverage saying the details on the allocation of \$6,000 between three

(Testimony of Grace McConnell.)

buildings will be furnished later, and asked for confirmation? [230]

A. We don't wire for coverage until we know how it is going to apply.

Q. That is your policy? A. Yes, sir.

Q. Now, this form, your personal policy, pardon me—— A. Yes, sir.

Q. ——this form, Mrs. McConnell, which was introduced in evidence and is attached in the pleadings to Plaintiff's Exhibit 2, is it your testimony that you sent a copy of that form along with your letter of April 9th? A. Yes, sir.

Q. Which is Plaintiff's Exhibit 2. You are sure that went out? A. Yes, sir.

Q. Do you say that because the letter says that it is enclosed? A. Are my initials on that letter?

Q. The letter of April 9th, yes, your signature is on it apparently.

A. Yes, sir, to my knowledge.

Q. This is a copy of that letter of April 9th, Plaintiff's Exhibit 2, apparently you wrote it for Mr. Coffey? A. Yes.

Q. And at the end of paragraph 2 you say "We are enclosing a form." [231] A. Yes, sir.

Q. That is the form just introduced in evidence?

A. Yes, sir.

Q. Do you say that form is enclosed in the letter because the letter says it is enclosed or do you recall the incident?

A. I couldn't swear, that is too much to expect of one's memory.

(Testimony of Grace McConnell.)

Q. Ordinarily you would have included the form, wouldn't you? A. Yes.

Q. I believe your testimony was you didn't receive that form back from Mr. Polimeni?

A. No, sir.

Q. How do you know you didn't receive it back?

A. Because we have his other two letters and it wasn't enclosed.

Q. Are you sure that form isn't knocking around in the office attached to some stray file?

A. No, sir.

Q. How can you be certain of that?

A. I remember the letter coming in and there was no form attached to it.

Q. You remember this letter of February 17th with the form in it? A. Yes, sir. [232]

Q. Did you open the mail?

A. Yes, I open all the mail.

Q. And you read Mr. Polimeni's letter?

A. Yes, sir.

Q. What did you do to it?

A. I gave it to the fire insurance girl.

Q. And what would her duties ordinarily have been, ordinarily?

A. She should have written a letter to Mr. Polimeni asking for a further breakdown.

Q. Don't you pass that sort of thing along to the boss, Mr. Coffey, and get his opinion on it?

A. No, not necessarily.

Q. Well, do you handle those matters yourself without referring them?

(Testimony of Grace McConnell.)

A. Ninety per cent of the business I handle myself.

Q. Did Mr. Coffey never see it?

A. It would be physically impossible for him to handle all the details.

Q. So many of these things?

A. Not on unprotected restaurants, no.

Q. Did you take this unprotected restaurant application to Mr. Coffey? A. No, sir.

Q. Rather you gave it to the insurance girl, did you? [232A] A. Yes, sir.

Q. Do you know what happened after she received it? A. That is when the letter was lost.

Q. Did she lose it?

A. No, I would say the carpenters.

Q. You say the carpenters lost it?

A. When they were taking down the partitions we had to move the files around and one morning when we came back to work things were in quite a mess. They had a lot of trouble trying to get them back together again and we didn't find that letter until July 23rd.

Q. That is 62 days after the date it was written?

A. There are an awful lot of papers in an insurance office.

Q. Is it your testimony, Mrs. McConnell, that an application for insurance protection on an unprotected restaurant being so difficult to acquire that you don't refer an important matter like that to Mr. Coffey himself?

(Testimony of Grace McConnell.)

A. No, I am perfectly capable of handling it myself.

Q. Under your own policies? A. Yes, sir.

Q. All right. When you received Mr. Polimeni's letter of April 9th, that is Plaintiff's Exhibit 2—

A. Mr. Polimeni's letter?

Q. Pardon me, Mr. Polimeni's letter of March 30th, Plaintiff's Exhibit 1, did you know when you read that letter [233] where the light plant was located, Mrs. McConnell?

A. No, he doesn't make the distinction whether it is away or in the building.

Q. I see. And what did you assume when you wrote your reply to that letter—the letter of April 9th with respect to the location of the light plant?

A. I would assume it was away from the building.

Q. And did you so assume when you quoted a rate of \$3 per one-hundred per year?

A. Yes, sir.

Q. And what would the rate have been if the light plant had been sitting on an open back porch?

A. I don't know. I know that the rate for a light plant by itself is \$1.70 a hundred.

Q. What would the rate on the building have been, that is, would it have been more than \$3 per hundred, of course?

A. That I don't know without checking in the rate book.

Q. Do you know that it would be greater?

A. I don't know that.

(Testimony of Grace McConnell.)

Q. You don't know whether it would be greater if the building——

Mr. Renfrew: If what?

Q. (By Mr. Nesbett): ——if the light plant were located on the back porch rather than away from the building? [234]

A. I don't know and without looking at a rate book——.

Q. I believe you testified this morning, did you not, Mrs. McConnell, that you initiated a file on Mr. Polimeni when you received this letter of March 30th?

A. That is right, I answered his inquiry.

Q. Didn't you already have a file on him concerning these other matters—the airplane and the Egigik property?

A. I had not been with Mr. Coffey's when Mr. Polimeni's dwelling was insured and I wasn't aware of it.

Q. You were with Mr. Coffey during the time that Mr. Polimeni was trying to collect on the Egigik kitchen fire, weren't you?

A. I didn't handle that at all. I heard about it from the girl who had been there before me and my recollection is that the insurance adjuster in Seattle couldn't pay or rather couldn't secure a check from the insurance company because he was unable to secure a signed proof of loss from Mr. Polimeni although he had written to him several times for it.

Q. Did you talk to Mr. Polimeni when he came into Anchorage about this loss?

(Testimony of Grace McConnell.)

A. No, I have never seen Mr. Polimeni before this trial.

Q. Did the other girl talk with him when he came in? A. I don't know.

Q. Well, Bill Sheahan had something to do with that handling of that loss? [235]

A. I thought Millie Moriarty.

Q. Now, when the insurance girl received this letter of April 23rd her duty—April 17th—pardon me—would have been to draft a reply to Mr. Polimeni, is that correct?

A. Well, it was her purpose to match it up with the existing file.

Q. But assuming that she had done that, then she would have written a letter from Mr. Polimeni asking for a breakdown? A. Yes, sir.

Q. Would any of this correspondence have gone over Mr. Coffey's desk? A. No, sir.

Q. He wouldn't have known what was going on at all? A. No, sir.

Q. How do you file your insurance problems or matters such as the Polimeni matter, Mrs. McConnell, what is the procedure?

A. We have a application for fire. The office work is departmentalized and the girl on the fire insurance desk has her own application suspense file.

Q. And that is the file that apparently got mislaid for sixty days? A. Yes, sir.

Q. Who did that contracting work, Mrs. McConnell? [236]

(Testimony of Grace McConnell.)

Mr. Renfrew: I am unable to hear you, Miss. Will you speak a little louder.

Q. (By Mr. Nesbett): Who did that work, Mrs. McConnell? I hate to shout at the woman.

A. You mean what is the name of the girl on the fire insurance?

Q. What is the name of the contractor who remodeled your offices?

A. I believe it was done in day labor. Murray Liblock did part of that.

Mr. Renfrew: How do you spell it?

The Witness: I don't know how to spell it. I remember offhand Murray Liblock. Well, the owner of the building would know.

Mr. Renfrew: Frank Lindelof?

The Witness: I don't really know.

Q. (By Mr. Nesbett): And the first name sounds like Murray to you?

A. Yes, but I didn't know their names.

Q. Do you recall how long they were engaged in that alteration?

A. Well, it was done quite piecemeal. First the partitions were down and then electricians came in and then linoleum was laid and painters came in and new desks came in and new [237] files. It was at least two months.

Q. Two months?

A. Before we were settled.

Q. Do you recall the date you worked—the approximate date the work was commenced, Mrs. McConnell?

(Testimony of Grace McConnell.)

A. I believe it was the latter part of April or the first part of May, we were doing quite a bit of work figuring out how to remodel to get more space.

Q. Of 1948? A. Yes, sir.

Q. Do you recall what instructions, if any, you gave the insurance girl when she got her letter of—when she got Tony's letter of—

A. —April 17th. I instructed her to write to Mr. Polimeni again to get a breakdown on the values of each building and the value of the equipment in each building.

Q. And then did you just turn the letter over to her? A. Yes, sir.

Q. And did you turn Mr. Polimeni's file over to her at the same time?

A. She had the original file; it was in her application-suspense.

Q. And do you know she had the original file?

A. Yes, sir.

Q. And do you as office manager have any means of checking [238] to see whether the girls reply to letters similar to that of April 17th?

A. I don't check everything unless they are brand-new employees. This girl had been on the desk since December—first part of December.

Q. Of 1947? A. Yes, sir.

Q. Well, don't you have a check also of some kind so that you will know the girl has done as you instructed her to do? A. No, sir.

Q. Who would have signed the letter that she wrote? A. She would have.

(Testimony of Grace McConnell.)

Q. And would have mailed it?

A. Yes, sir. Well, we have one girl put up all the mail. Each girl does not put up her own mail.

Q. Well, she would have written the letter, signed it and turned it over to the mail girl?

A. Yes, sir.

Q. And then you didn't know whether or not she had answered that letter of April 17th at all until you received Mr. Polimeni's letter of June 1st, did you? A. No.

Q. And what did you do then, did you open that letter, Miss McConnell? A. Yes, sir.

Q. What did you do when you saw that letter of June 4th [239]

Mr. Renfrew: Which exhibit is that?

Mr. Nesbett: That is Plaintiff's Exhibit 4.

The Witness: I asked the girl.

Mr. Renfrew: Just a moment, now, Plaintiff's Exhibit 4?

Mr. Nesbett: The letter of June 1st, Plaintiff's Exhibit 4.

Mr. Renfrew: That is the letter of Mr. Polimeni's. The answer to that—that is the letter of June 1st instead of June 4th.

Mr. Nesbett: Can't you follow the tone of the questioning? I said the letter of June 1st, 1948, Plaintiff's Exhibit 4.

Mr. Renfrew: I misunderstood you. I thought you said June 4th, excuse me.

Q. (By Mr. Nesbett): Exhibit 4, June 1st. Now you saw the letter, did you not, Mrs. McConnell?

(Testimony of Grace McConnell.)

A. Yes, sir.

Q. And did you read it? A. Yes, sir.

Q. And what did you do after you read it?

A. I asked her to give me her file on it.

Q. The fire insurance girl?

A. On the fire insurance desk. [240]

Q. Then what happened?

A. She brought me the file which was the original inquiry and our reply quoting the rate and I told her that there was another letter which came in giving us details concerning it and she said "I can't find it."

Q. And then what did you do as office manager?

A. We all tried to find it.

Q. And what did you do in your attempt?

A. Well, we went through all the correspondence files which this girl had on her desk.

Q. The insurance girl?

A. The fire insurance girl.

Q. And what else?

A. When we couldn't find it I told her to write to Mr. Polimeni and get the information again.

Q. How long did you look for it, do you recall?

A. No, not more than a day.

Q. Then I presume Plaintiff's Exhibit 5, the letter of June 4th to Mr. Polimeni written by, apparently, Edmond McCord? A. Yes.

Q. She was the fire insurance girl?

A. Yes.

Q. Is the reply you directed her to write?

A. Yes, sir.

(Testimony of Grace McConnell.)

Q. After looking for Mr. Polimeni's letter one day? [241] A. Yes, sir.

Q. Did you make any other attempt to locate it after that one day search? A. No, I didn't.

Q. Did you keep the Polimeni file on your desk after that unsuccessful search in order to remind you to look again?

A. No, it was kept on this other girl's desk.

Q. You just forgot about the thing assuming that Polimeni would sooner or later send you the information—rather send you the other again?

A. Yes, sir.

Q. Well, can you tell me why when you told Mrs. McCord to write the letter of June 4th you didn't also tell her to have Tony designate how he wanted that insurance divided between the three buildings?

A. I probably didn't remember that he had three buildings.

Q. Oh, you forgot and in his letter of April 18th he had listed three buildings? A. Yes, sir.

Q. Can you state whether or not Mr. Coffey was in the office between March 30th and, oh, July 23rd?

A. He took one trip to Seattle during that time but I don't recall the exact period?

Q. Was it during this reconstruction period when the rebuilding period of the office, Mrs. McConnell, or do you [242] know? A. I believe it was.

Q. And do you recall how long that trip lasted?

A. No, I don't.

Q. Do you recall approximately how long it lasted?

(Testimony of Grace McConnell.)

A. Well, he usually was gone about ten days.

Q. Usually, you mean each time he goes down?

A. Yes.

Q. Would you say that it was about ten days this time?

A. That is my recollection.

Q. During the rebuilding of the office?

A. Yes, sir.

Q. In any event though, Mrs. McConnell, isn't it your testimony that even though he had been in the office during all the period of this correspondence ordinarily he wouldn't have been bothered with such matters as passing on Tony's application?

A. No, sir.

Q. He would not have been?

A. He would—no.

Q. Did it ever occur to you when you received Tony's letter of June 1st, Plaintiff's Exhibit 4, to go ahead and send some *some* type wire to Seattle to try and protect his restaurant building or get the thing rolling—the ball rolling on it? [243]

A. I told you I didn't submit risks without full details and particulars.

Q. Well, in all your twenty years' experience as an underwriter and under supervision and in offices, wouldn't it have been good practice to go to Mr. Coffey when you received that letter of June 1st and said "Look, Mr. Coffey, I am sure Tony sent us a lot of information, it has been lost and here it is June 1st, he is inquiring about it, isn't there some-

(Testimony of Grace McConnell.)

way we can do something about it" wouldn't you ordinarily have done that?

A. Well, please remember, Mr. Nesbett, we were working under extreme duress at the time. If there hadn't been so much confusion I probably would have handled it more efficiently.

Q. More efficiently. Was Mr. Coffey there when you discovered, finally found this letter of July 23rd?

A. Yes, I think he was. If I recall he was outside in June.

Q. Did you go to Mr. Coffey then before you wrote this letter of June 23rd to Tony?

A. No, sir.

Q. He knew nothing about this whole thing?

A. Not until the fire was reported.

Q. Who discovered this letter of June or July 23rd? A. Mary Kaser.

Q. Do you know the circumstances under which she discovered [244] it?

A. As I recall, she brought it to me and asked me if this wasn't the letter that I had been looking for and I asked her where did she find it and she said that it was stuck in Evelyn's desk underneath another file.

Q. Evelyn McCord? A. Yes.

Q. The fire insurance girl? A. Yes.

Q. Underneath another file?

A. Yes, it was under a clip.

Q. Under a clip?

A. Yes, so it appeared to be part of another file.

(Testimony of Grace McConnell.)

Q. I see. And do you know how Mary Kaser happened to find it?

A. She was looking for something else.

Q. On Mrs. McCord's desk? A. Yes.

Q. I believe you testified on your direct examination, Mrs. McConnell, did you not, in response to one of Mr. Renfrew's questions that when you wrote this letter of June 4th, which is Plaintiff's Exhibit 5, you did not have the information that Mr. Polimeni desired to insure three buildings rather than one? A. It wasn't debatable. [245]

Q. Well, as a matter of fact, you had it; it was in the office but you couldn't find it, isn't that it?

A. Yes, sire, we didn't find it to refer to.

Q. Would you consider Mr. Polimeni's restaurant in view of the description contained in the letter of April 17th a greater hazard than the Nenana restaurant?

A. I am not familiar with either location.

Q. Mrs. McConnell, at the time you wrote the letter of July 23rd, Plaintiff's Exhibit 6 wherein you said "We wish to apologize" et cetera, at the time you wrote that letter it would have been possible to obtain insurance for Mr. Polimeni in some company through Mr. Coffey's arrangement, wouldn't it?

A. It turned out that way with the Nenana risk.

Q. It would have been possible, would it not?

A. Assuming that the companies would accept it as they had the Nenana risk. That is an assumption.

Q. Then was that in the back of your mind when

(Testimony of Grace McConnell.)

you said to Tony in the last paragraph of that letter
“Will you kindly give us this information so we
may issue your policies”? A. Yes, sir.

Q. You didn't quite say what you meant then in
the last paragraph of that letter, did you?

A. The word “issue” is used entirely too loosely.

Q. You didn't mean that at all?

A. Not in the sense you did. [246]

Q. Not in the ordinary insurance sense, is that
correct? A. Yes.

Mr. Nesbett: I believe that is all, Your Honor.

Mr. Renfrew: I don't believe I have any exami-
nation, Your Honor.

(Witness excused.)

Mr. Renfrew: I have a witness I haven't called
and I would like to have a five-minute recess so I
could get him here.

The Court: Court will be in recess five minutes.

Mr. Nesbett: Your Honor, may I recall Mrs.
McConnell for one question.

The Court: Yes.

(Grace McConnell resumed the witness stand.)

Q. (By Mr. Nesbett): Mrs. McConnell, with
respect to the Nenana restaurant to which you tes-
tified, isn't it a fact in 1948 they had a very severe
fire in Nenana?

A. I wasn't aware of it, Mr. Nesbett.

Q. You don't know whether there was such a
fire or not? A. No, I don't.

(Testimony of Grace McConnell.)

Q. Do you know the reason for it being so difficult to place that Nenana risk?

A. From our correspondence I concluded it was just because it was an unprotected restaurant. [247]

Mr. Nesbett: I see, thank you.

Further Redirect Examination

By Mr. Renfrew:

Q. In that connection, Mrs. McConnell, were there any other unprotected restaurants cancelled that spring that you had covering on?

A. Yes, we had Fire Lake Lodge. Do you want the particulars?

Q. Just state briefly what occurred in that risk, was that an unprotected restaurant?

A. The Fire Lake Lodge is right up the highway and I understand that it is both a restaurant and cocktail bar.

Q. Yes.

A. From May 14, '47, to May 14, '48, we had a policy in the American Home. When it expired we automatically renewed it in our office at the request of our insured and we receipted for wire from Gould & Gould reading "Cancel Immediately American Home Policies 4263 and 4264 Best American Cannot Write."

Q. There haven't been any big fires at Fire Lake that you know of, have there?

A. Not at that time.

Q. On your previous examination by Mr. Nes-

(Testimony of Grace McConnell.)

you said to Tony in the last paragraph of that letter
“Will you kindly give us this information so we
may issue your policies”? A. Yes, sir.

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Q. On your previous examination by Mr. Nes-

(Testimony of Grace McConnell.)

bett you testified that you might have been able to have handled this man's more efficiently, do you have any explanation to make of how you could handle this more efficiently? [248]

A. The only thing I can think of would be instead of writing Mr. Polimeni we could have wired him for that information again.

Q. You could have done that? A. Yes, sir.

Mr. Renfrew: I think that is all.

Further Recross-Examination

Q. (By Mr. Nesbett): Mrs. McConnell,—this causes me to ask just a few more questions, Your Honor—Mrs. McConnell, you say you automatically renewed the policies on the Fire Lake property?

A. Yes, sir.

Q. That was unprotected property—bar and restaurant—wasn't it?

A. But the American Home had not yet told us they wouldn't write it.

Q. You had the right to bind the American Home?

A. We could renew anything automatically that was already accepted by the Company unless we had previous instructions otherwise.

Q. Without checking with the Company at all?

A. No.

Q. Could you have written an unprotected restaurant binding the American Home for \$1500 or \$2500?

A. No, we never bind a new risk. [249]

(Testimony of Grace McConnell.)

Q. Could you have done that with any of your companies? You had that power with some of them, didn't you?

A. Based on verbal instructions when I was in Seattle before I came to Anchorage——

Q. No, I am asking you, Mrs. McConnell, if as office procedure, you were office manager and Mr. Coffey was away quite a bit of the time, didn't you have the power to bind some of these companies that he represented as agent?

A. We had the power to bind subject to instructions.

Q. As Mr. Coffey testified some \$1500 and some \$2500, isn't that correct? A. There were two.

Q. Isn't it a fact that in the spring or summer of 1948 the Fire Lake had quite a disastrous fire at Fire Lake Lodge?

A. I don't believe it was before May, 1948.

Q. Well—yes, it would have been before the expiration of their policy, would it not, their policy expired in May of 1948 and you automatically renewed them, didn't you, May 14, '47, to May 14, '48?

A. Yes, sir.

Q. And isn't it a fact that before the expiration of the policies on May 14, '48, that three or four cabins burned at Fire Lake, burning up at least one man?

A. But they weren't carrying any insurance on the cabins; they were carrying it on the main building. [250]

Q. But that does—did occur, didn't it?

(Testimony of Grace McConnell.)

A. I recall the fire; I don't recall the date.

Q. When you say you could have handled it more efficiently by wiring, Mrs. McConnell, isn't it a fact that you could have handled it much more efficiently if when you received Mr. Polimeni's wire of June 1st saying "What cooks with respect to my insurance" and you answered or directed Mrs. McCord to answer on June 4th, you could have told him to tell us in that letter—Mr. Polimeni, you say the allocation on the insurance on each of those three buildings, you could have done that, couldn't you?

A. Yes.

Further Redirect Examination

By Mr. Renfrew:

Q. You would have had to remember it, however, in order to do it? A. Yes, sir.

Mr. Renfrew: I want to call Mr. Polimeni for about two questions.

Mr. Nesbett: Do you need Bill Smith?

Mr. Renfrew: I don't think we need Bill Smith.

ANTONIO POLIMENI

Further Recross-Examination

By Mr. Renfrew:

Your Honor, I want to ask this man from whom he bought this restaurant. Does Your Honor wish to ask the [251] question of him? He seems to be hard of hearing. Do you hear me?

A. A little bit. I hear it now.

(Testimony of Antonio Polimeni.)

Q. Who did you buy the restaurant from?

A. Restaurant, Billy Reagan.

Q. You bought it from Billy Reagan?

A. Commission. I remember Billy Reagan, suppose to give. He gave it to me too because I work for him, cook for the kid until the cook fellows got back every year to send to school. Every morning and then Billy promise, on the 15th he says. In '32 he got some mixed up with Charles Once, you see. I say Charles Once the rest of our restaurant and forget it. Well, Billy Reagan he passing away in years—a couple of years—the restaurant belong to you. To fellows he promised it to me. After awhile he said “I think Tony you had better be buying it” you see, previous to that Mrs. Davis she tell—Billy told her. I was here. I seen her a little while ago.

Q. Wait just a moment.

A. Freida——

Q. Stop, cease and desist. You bought the restaurant from Billy Reagan?

A. Yes, the Commissioner.

Q. Did you get any paper? A. What?

Q. Did you get any paper from him? [252]

A. He got a receipt paid up, bought them up everything. Burned up everything.

Q. Did the paper—Did the paper you got from Billy Reagan burn up? A. He die.

Q. You got the paper from Marchbanks?

A. A receipt.

Q. Did that burn up? A. Burn up.

Mr. Renfrew: That is all.

(Testimony of Antonio Polimeni.)

Mr. Nesbett: Your Honor, while Mr. Polimeni is on the stand, I wonder if I could go into that matter that I made an offer of proof on?

The Court: The only way, you can make an offer of proof.

Mr. Nesbett: Rather than that, Your Honor suggested that I make an offer of proof?

The Court: Yes, but not by asking the witness questions.

Mr. Nesbett: I understand that, Your Honor, but may I ask him the questions now?

The Court: For what purpose?

Mr. Nesbett: To further bear out our contention.

The Court: That overlooks the fact that I have ruled against it and so your only recourse is to make an offer of [253] proof.

Mr. Renfrew: Call Mr. Dan Cuddy.

DANIEL CUDDY

called as a witness on behalf of the defendant, being duly sworn, testified as follows:

Direct Examination

By Mr. Renfrew:

Q. Mr. Cuddy, your name is Daniel Cuddy?

A. That is correct.

Q. You are an attorney practicing in Anchorage?

A. That is correct.

Q. I will ask you whether or not the firm with which you are connected administered the—was at—

(Testimony of Daniel Cuddy.)

torney for the Administrator of the Estate of William Reagan? A. They are and were.

Q. As attorney for that estate do you have copies of the files? A. Yes, sir.

Q. Will you state the approximate date of the demise of Mr. Reagan?

Mr. Nesbett: Your Honor, I think Mr. Cuddy should be qualified to testify. There is no testimony that he has acted as attorney for these estates and it is common knowledge that he has only been in the office a very short while. He may not know about these estates at all and may not be qualified to [254] testify.

The Court: I am not sure that I get your objection. He could learn of the facts to which he has already testified without being in the office from the time that they were retained for this purpose.

Mr. Nesbett: Then there is nothing to show that the files in Mr. Cuddy's possession now are the complete file on the Reagan Estate and how would he know if he didn't act as attorney for the Administrator?

The Court: He would be in the same position of any custodian of records who succeeds another custodian, he wouldn't be precluded from going beyond or prior to his tenure of office. Objection is overruled.

Mr. Nesbett: Is he the custodian though, Your Honor?

The Court: Well, I thought that your objection was based on the—on his status as a custodian or

(Testimony of Daniel Cuddy.)

the fact that his custody didn't go back far enough and I hold that that objection is not well taken. Go ahead.

Q. (By Mr. Renfrew): Do your records from the file of your office show the date of the demise of Mr. Reagan?

A. They would, I would have to check on it. He died to my recollection in '42 or '43, quite a while ago.

Q. Have you checked the inventory and appraisal in his estate to determine whether or not he had any interest [255] in any restaurant building or any building in South Naknek, Alaska?

A. Yes, I did.

Q. Did he or did he not have any at the time of his death?

A. The inventory which was not prepared by our office did not show an interest in the restaurant.

Q. Now, since the administration has started have you corresponded with the United States Commissioner at Naknek, Mr. Marchbanks, with regards to this so-called restaurant property in South Naknek?

A. I have.

Q. And do you have a reply from Mr. Marchbanks in his capacity as United States Commissioner with reference to that property?

A. I have.

Q. And what is the date of that reply?

A. August 23, 1948.

Q. And what does that reply state, if anything, with regards to the property at South Naknek?

Mr. Nesbett: I object, Your Honor, to this unless

(Testimony of Daniel Cuddy.)

it is pinned down to be the same property that is involved in this case; there is nothing to show that it is.

The Court: I assume that he would certainly identify it as such so that if the ground of your objection is that the Court will have to overrule it. [256]

Mr. Nesbett: If Your Honor please, South Naknek restaurant property, it is impossible for Mr. Cuddy to know whether it is the same property or not.

The Court: My ruling indicates that it is just the situation where the witness or the attorney questioned cannot be expected to bring out everything in one question and answer; they have to have the opportunity and so on that ground the objection is overruled.

Mr. Renfrew: I will go into it a little further, Your Honor, and help Mr. Nesbett clear it up; maybe it isn't clear to the Jury.

Q. Are you familiar with that file to the extent of having knowledge concerning the file?

A. I am quite familiar with the file.

Q. Do you know Mr. Polimeni claimed an interest in a restaurant in South Naknek?

A. I know that a man informed me that Billy Reagan had an interest in a restaurant and I wrote Mr. Marchbanks who originally filed the administration of this estate to ask him for information and why it was not included in the inventory?

(Testimony of Daniel Cuddy.)

Q. And what was his reply?

A. I might add there was another item that is included in this with regard to a \$400 check of Mr. Polimeni.

Q. State that again?

A. There was a \$400 check that turned up in the files [257] when I took over the administration of the estate handling it for the administrator.

Q. Yes.

A. And I had asked Mr. Marchbanks also about this check.

Q. The check was made payable to who?

A. It was payable to Mr. Polimeni.

Q. Polimeni? A. Yes.

Q. Now, in connection with that and in connection with the restaurant in South Naknek, did you inquire of Mr. Marchbanks as to whether or not Reagan or his estate had any interest in the South Naknek Restaurant property?

A. I did and this is the answer I got:

“Dear Mr. Cuddy:

“In answer to your letter of June 9, 1948, concerning the check you are holding for Antonio Polimeni for \$400, will you kindly return the check to my office. According to our records William B. Reagan, deceased, has no interest in the restaurant at South Naknek, Alaska. The other estate to which the restaurant belongs has never been administered. All papers concerning the William B. Reagan Estate which you mailed us under date of June 3, 1948,

(Testimony of Daniel Cuddy.)

have been properly filed * * *." And then it goes on to some other matters.

Q. What is the date of that letter from Mr. Marchbanks? A. August 23, 1948. [258]

Mr. Renfrew: That is all, Mr. Cuddy. Your witness.

Cross-Examination

By Mr. Nesbett:

Q. What does the other estate refer to?

A. It doesn't state in this letter.

Q. You don't recall whether you represent the Administrator for that other estate then?

A. It was never probated, to my knowledge.

Q. If you don't know which estate it was how do you know it was never probated?

A. Mr. Marchbanks said it never was.

Q. You don't know the name of the estate even?

A. No, sir.

Q. What did you do with that check for \$400?

A. Mailed it back to Mr. Marchbanks.

Q. And has anything been done on the estate since August of 1948?

Mr. Renfrew: What estate?

Mr. Nesbett: The only estate involved here—Reagan's Estate.

A. It is—the order of distribution has been entered.

Q. And when was that done?

A. That was done about three months ago.

Q. And has Marchbanks signed it?

(Testimony of Daniel Cuddy.)

A. Marchbanks is no longer the Commissioner. [259]

Q. Who is handling it now as Commissioner?

A. A woman by the name of Helen Tibbetts.

Mr. Nesbett: No further questions.

Mr. Renfrew: That is all Mr. Cuddy.

(Witness excused)

Mr. Renfrew: We rest, Your Honor.

The Court: Have you any rebuttal?

Mr. Nesbett: I thought Mr. Coffey would take the stand or they would have another witness. May I have five minutes to go through my notes and see if I have any rebuttal?

Mr. Renfrew: What was that first remark?

The Court: He said something to the effect that he thought Mr. Coffey would take the stand.

Mr. Nesbett: What I want is a few minutes.

The Court: Do you want a five minute recess?

Mr. Nesbett: Mr. Bill Smith.

BILL SMITH

previously called as a witness, being previously sworn, resumed the stand and testified as follows:

Further Redirect Examination

By Mr. Nesbett:

Q. You heard Mr. Cuddy's testimony that he was attorney for the Administrator of the Estate of William Reagan did you not? A. Yes. [260]

(Testimony of Bill Smith.)

Q. You heard his testimony that Mr. Reagan died in 1942 did you not? A. Yes.

Q. I will ask you whether or not you were in Naknek when Mr. Reagan died? A. Yes.

Q. What year did he die? A. 1946.

Q. How do you know that, Mr. Smith?

A. Mr. Reagan had been very ill for sometime with cancer and he had trouble with his circulation, couldn't walk, he would come into Anchorage to the Providence Hospital and spend some time there and Mr. Phillips of the Alaska Packers Association had come in to consult the hospital about Mr. Reagan's condition.

Mr. Renfrew: Objected to as hearsay.

The Court: Objection is sustained.

Q. (By Mr. Nesbett): Were you there when that happened?

Mr. Renfrew: What happened?

Q. (By Mr. Nesbett): The hospital visit?

A. Yes, sir, I hauled Mr. Phillips.

Q. You hauled him in your plane?

A. Not all the way to Anchorage, just to the Naknek [261] Air Base.

Mr. Renfrew: I made an objection, Your Honor.

The Witness: I can qualify it.

The Court: This is another question now, is it not?

Mr. Renfrew: No.

Mr. Nesbett: I asked did you haul him to Anchorage in your airplane?

A. I didn't haul him all the way to Anchorage.

(Testimony of Bill Smith.)

Q. How far did you haul him?

A. To the Naknek Air Base.

Q. What year was that? A. 1946.

Q. Was he ill at that time?

A. You are speaking of Mr. Reagan?

Q. Mr. Reagan, yes, sir.

A. Oh, yes, he was ill. I had reference to Mr. Phillips to the Base.

Q. Well, tell us how you know Mr. Reagan died in 1946?

A. Mr. Phillips brought Mr. Reagan back to Naknek to straighten the accounts of the Alaska Packers and I had my airplane parked on the beach.

Mr. Renfrew: Your Honor, to simplify this thing, I will stipulate, if you know when he died, the date that he did die. I can't see that it is material. As I recall Mr. Cuddy's testimony he said he would have to check through [262] the records. If you say you saw him die I will stipulate.

Q. (By Mr. Nesbett): All right, what part of 1946 did he die?

A. He died in the latter part of the summer.

Q. Of '46, you know that yourself?

A. Yes.

Mr. Renfrew: I will stipulate to that fact.

Mr. Nesbett: Thank you.

Q. Was Mr. Reagan Administrator of any estates in and around Naknek? A. Yes.

Q. What estates to your knowledge?

A. Heinz Smchook Estate.

(Testimony of Bill Smith.)

Q. And was Mr. Marchbanks the United States Commissioner handling those estates also?

A. Yes.

Q. And do you know whether or not the Heinz Smchook Estate had any interest in this property which later became Tony's?

A. I don't know positively.

Mr. Nesbett: That is all, Your Honor.

Mr. Renfrew: That is all.

Mr. Nesbett: We rest, Your Honor.

Mr. Renfrew: We rest. I wish to renew my motions, Your Honor.

The Court: Have you anything further to [263] add than what you already stated?

Mr. Renfrew. I have nothing further to add except that I can talk for two hours and one half on what we have already stated. I can't see, Your Honor, that there is a possible question here to go to the jury.

Mr. Nesbett: I object to any argument in front of the jury.

The Court: The motion is denied.

Mr. Nesbett: I, of course, Your Honor, want to make my statement to Your Honor as an offer of proof, is that sufficient or shall I restate it in the absence of the jury?

The Court: The offer should be, of course, made in the usual way and from what I recall of its character it is not something that would be improper to make in the presence of the jury unless counsel objects.

Mr. Renfrew: Your Honor, when the plaintiff said that he rested I assume that he meant what he said. If he wishes to reopen his case I can see this matter going on ad infinitum practically. If he wishes to reopen his case to make an offer of proof then the Court has practically walked down off the bench and told him how. If he wants to make an offer and he is allowed to make it then the case is reopened and we have to submit evidence in opposition to it, if the Court allows it.

The Court: I have already said that I wouldn't allow [264] it to be introduced but, of course, he has the right to make an offer.

Mr. Renfrew: He is doing that, I suppose, for the purpose of the record, and the record only?

The Court: Yes.

Mr. Renfrew: Then what is the purpose, Your Honor, in doing it in any way other than the proper way?

Mr. Nesbett: I don't know, Your Honor, whether you want to dismiss the jury or whether we should come to the bench and make it.

Mr. Renfrew: I think an offer of proof in any other way than one way, unless I don't know how you do it, and I think that is in writing. I will explain it if it is necessary.

The Court: It will have to be in writing or at the bench unless of such a character that it could probably be made in the presence and hearing of the jury and from what you have said of your offer heretofore it seems to me it could be made in the presence of the jury without any prejudice what-

ever ensuing. Now, if, however, you object to it being made in the presence of the jury then counsel should come to the bench and make it.

Mr. Renfrew: I certainly object to that offer being made in the presence of the jury.

The Court: All right, you may make it at the bench. [265]

(Counsel approached the bench.)

Mr. Nesbett: I desire, Your Honor, to offer proof of the following facts by the testimony of Mr. Polimeni himself, the plaintiff, that in the latter part of the year, 1947 or of early in the year 1948, Mr. Polimeni travelled to Anchorage to discuss with Mr. Coffey or his assistants payment of Mr. Polimeni's claim for insurance as a result—

The Court: You don't have to include why he came to Anchorage. The only thing is just state what you intend.

Mr. Nesbett: I am right to that now—payment of this claim; that while in Mr. Coffey's office he talked with Mr. Coffey and stated to Mr. Coffey that he, Mr. Polimeni, had a restaurant in Naknek which he desired to insure with Mr. Coffey; that Mr. Coffey agreed that he would insure it and asked if Mr. Polimeni wanted it insured then. Mr. Polimeni replied that he still had a little work to do on the restaurant and wanted to find out exactly what he had in it and that he would take the matter up with Coffey later; that Coffey agreed to take the matter up for Mr. Polimeni at a later date.

The Court: Having already ruled that no action

lies on contract and it being obvious that this testimony would be admissible only if that action were still in the case, the offer is declined because it is irrelevant now.

(Counsel returned to the counsel tables.) [266]

United States of America,
Territory of Alaska—ss.

I, Oren J. Casey, the Official Court Shorthand Reporter for the District Court of the United States, Third Division, Territory of Alaska, hereby certify the above and foregoing pages numbered 189 through 266 to be a true, complete and correct transcript of the testimony taken in the above-entitled action on the 20th day of April, 1950.

/s/ OREN J. CASEY,

Certified Shorthand Reporter.

[Endorsed]: Filed August 15, 1950. [267]

[Title of District Court and Cause.]

CERTIFICATE OF CLERK TO RECORD
ON APPEAL

I, M. E. S. Brunelle, Clerk of the above-entitled Court, do hereby certify that pursuant to the provisions of Rule 11 (1) of the United States Court of Appeals for the Ninth Circuit, as amended, and pursuant to the provisions of Rules 75 (g) (o) of the Federal Rules of Civil Procedure, and pursuant to designation of counsel, I am transmitting herewith the original papers in my office dealing with the above-entitled action or proceedings, and including specifically the complete record and file of such action, including the reporter's transcript of the evidence introduced on the trial of the cause, and all the exhibits introduced by the respective parties, namely plaintiff's exhibits 1 to 9, inclusive, and defendant's exhibits A and B, such record being the complete record of the cause pursuant to the said designation.

The papers herewith transmitted constitute the record on appeal from the judgment filed and entered in the above-entitled cause by the above-entitled Court on April 27, 1950, to the United States Court of Appeals at San Francisco, California.

[Seal] /s/ M. E. S. BRUNELLE,
Clerk of the District Court for the Territory of
Alaska, Third Division.

[Endorsed]: No. 12659. United States Court of Appeals for the Ninth Circuit. Edward D. Coffey, Appellant, vs. Antonio Polimeni, Appellee. Transcript of Record. Appeal from the District Court for the Territory of Alaska, Third Division.

Filed August 21, 1950.

/s/ PAUL P. O'BRIEN,
Clerk of the United States Court of Appeals for
the Ninth Circuit.

In the United States Court of Appeals
For the Ninth Circuit

No. 12659

EDWARD D. COFFEY,

Appellant,

vs.

ANTONIO POLIMENI,

Appellee.

APPELLANT'S DESIGNATION OF POINTS
UPON WHICH HE INTENDS TO RELY
ON APPEAL

Comes now appellant, Edward D. Coffey, and pursuant to Rule 19 of the above-entitled Court, sets forth the points upon which he intends to rely on this appeal, namely:

1. That appellant was under no duty to attempt to procure insurance for appellee, Antonio Polimeni,

and accordingly plaintiff's attempted statement of a cause of action against defendant-appellant Coffey on the ground of alleged negligence does not state any cause of action in favor of the plaintiff-appellee and against the defendant-appellant, and such attempted cause of action should have been dismissed, by the Court, on motion of defendant-appellant.

2. That the Court erred in refusing to grant the motion of defendant-appellant for dismissal of the action, or for direction of verdict in favor of appellant, such motion having been made at the close of plaintiff's case and at the close of all the evidence.

3. That in any event there is no evidence in this cause showing any duty of appellant toward appellee or showing any negligence of appellant in connection with the matter attempted to be alleged by plaintiff-appellant, or, in the alternative, if the Court should find that there was a duty owing by appellant to appellee sufficient to support an action in negligence by appellee against appellant that on the face of the record appellee was guilty of such contributory negligence that the Court should have decided as a matter of law that no recovery could be had against appellant by appellee in connection with such alleged negligence.

4. That the Court erred in submitting the matter to the jury at all.

5. That the Court erred in accepting the verdict of the jury.

6. That the Court erred in entering judgment in favor of appellee and against appellant in this matter.

7. That the Court erred in overruling appellant's motion to set aside the verdict and the judgment, and in refusing to enter judgment in favor of appellant, notwithstanding the verdict.

8. That the Court erred in refusing to grant a new trial in the matter on the request of appellant.

9. That the verdict as rendered by the jury, if in fact any verdict in favor of appellee and against appellant is justified, is grossly excessive, is not supported by any substantial evidence, and is such that it must necessarily have been rendered as a result of sympathy or passion or prejudice.

Respectfully submitted,

DAVIS & RENFREW,
Attorneys for Defendant-Appellant, Edward D.
Coffey,

By /s/ EDWARD V. DAVIS.

Receipt of Copy acknowledged.

[Endorsed]: Filed August 28, 1950.

[Title of Court of Appeal and Cause.]

STIPULATION CONCERNING PRINTING OF RECORD

It is hereby stipulated and agreed by and between Davis & Renfrew, attorneys for the appellant, and McCutcheon & Nesbett, attorneys for the appellee, that the entire record in the above matter as submitted to the Court of Appeals by the District Court, together with this stipulation and together with appellant's designation of points, shall be printed, except those certain portions hereinafter particularly set forth which are not material to the determination of the questions raised by the appeal of this matter, or which are duplications of other portions of the record and may be omitted from the printed record by the Clerk of the above-entitled Court as follows:

1. The printed paper marked "Judgment Roll."
2. Summons directed to defendant dated February 11, 1949, filed February 16, 1949.
3. Summons dated April 7, 1949, and filed April 19, 1949.
4. Stipulation for extension of time to answer.
5. Minute Order of the Court, setting all cases for trial one to follow another.
6. Demand for jury trial.
7. Stipulation concerning amount of supersedeas bond.

8. Order setting amount of supersedeas bond, such order being dated May 24, 1950.

9. Supersedeas bond filed by appellant.

That in addition to the portions of the record which need not be printed by stipulation of the parties as above set forth, appellant requested that certain other portions of the record not be printed by reason of the fact that such portions are duplications of parts of the record which are being printed, and that such portions which appellant would have omitted are as follows:

1. Exhibit A attached to plaintiff's complaint, for the reason that such exhibit is a duplicate of letter dated April 17, 1948, written by Antonio Polimeni to Edward D. Coffey, which has been introduced into evidence in this matter as plaintiff's Exhibit III, which is being printed.

2. Exhibits I, II, III, IV, V, VI, VII, VIII and IX attached to defendant's Answer, by reason of the fact that all of such exhibits are duplicated by plaintiff's Exhibits I through IX, inclusive, introduced at the trial, save and except Form Number 7080, which is part of Exhibit Number II attached to defendant's Answer, and of which a duplicate has been admitted into evidence in this matter as defendant's Exhibit B, which are being printed.

3. Minute Order dated April 17, 1950, concerning drawing of the Jury, for the reason that a legal jury was admittedly drawn and the Minute Order

concerning drawing of the jury is immaterial on this appeal.

4. Minute Order dated April 17, 1950, concerning the swearing of the jury, for the reason that a legal jury was admittedly drawn and sworn and the Minute Order concerning the swearing of the jury is immaterial on this appeal.

5. Subpoena for the attendance of Joseph Sheahan as a witness, for the reason that Joseph Sheahan was admittedly called as a witness on behalf of plaintiff, and the actual subpoena issued by the Court for his appearance is immaterial on this appeal.

6. Cost Bill filed by the plaintiff on May 3, 1950, for the reason that there is no question concerning the Cost Bill, and appellant is willing to stipulate that in the event appellant is liable to appellee in accordance with the Judgment, that he is likewise liable to pay the costs according to such Judgment.

Appellee has declined to stipulate for the exclusion of the above-mentioned items 1 through 6, both numbers inclusive, from the printed record, and has requested that they be printed along with other portions of the record.

Dated at Anchorage, Alaska, this 13th day of September, 1950.

DAVIS & RENFREW,
Attorneys for Defendant-
Appellant.

By /s/ EDWARD V. DAVIS.

McCUTCHEON & NESBETT,
Attorneys for Plaintiff-
Appellee,

By /s/ BUELL A. NESBETT.

[Endorsed]: Filed September 18, 1950.

No. 12,659

IN THE
United States Court of Appeals
For the Ninth Circuit

EDWARD D. COFFEY,

VS.

ANTONIO POLIMENI,

Appellant,

Appellee.

Appeal from the District Court, Territory of Alaska,
Third Division.

BRIEF OF APPELLANT.

DAVIS & RENFREW,

Box 477, Anchorage, Alaska,

Attorneys for Appellant.

FILED

1931

PAUL D. SMITH
CLERK

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No. 12,659

IN THE

**United States Court of Appeals
For the Ninth Circuit**

EDWARD D. COFFEY,

vs.

ANTONIO POLIMENI,

Appellant,

Appellee.

Appeal from the District Court, Territory of Alaska,
Third Division.

BRIEF OF APPELLANT.

I.

STATEMENT RELATING TO PLEADING AND JURISDICTION.

This is an appeal from a final judgment rendered April 27, 1950, by the District Court for the Territory of Alaska, Third Division, in favor of appellee, Antonio Polimeni, and against appellant, Edward D. Coffey, in the sum of \$9,200.00, costs, and attorneys' fees (R 57-58).

The District Court for the Territory of Alaska is a Court of General Jurisdiction consisting of four divisions of which the Third Division is one. Jurisdiction of the District Court is conferred by Title 48

U.S.C. Sec. 101. See also Alaska Compiled Laws Annotated, 1949, 53-1-1.

Jurisdiction of this Court to review the judgment of the District Court is conferred by New Title 28 U.S.C., Sections 1291 and 1294.

Appellee, as plaintiff in the District Court, by his complaint alleged two causes of action. The first was for the sum of \$10,000 for damages alleged to have resulted to plaintiff by reason of claimed negligence by appellant in failing to secure certain insurance which appellee claimed appellant had undertaken to procure for appellee (R 2-4). The second cause of action realleged by reference the first four paragraphs of the first cause of action and in brief claimed the sum of \$10,000 as damages in favor of appellee by reason of claimed breach of contract by appellant to insure the property in question (R 4-6). At the beginning of the trial and by leave of the Court appellee amended his complaint to allege the date of the fire as July 20, 1948, instead of July 9, 1948, as originally alleged (R 25). Later the Court allowed plaintiff to amend his complaint to exclude two auxiliary buildings from the claimed loss (R 29-30). Both amendments were made by interlineation, and the complaint as it appears in the record is the complaint as amended, not the complaint as it was originally filed.

Answer filed by appellant as to the first cause of action of appellee's complaint denied any undertaking by appellant to secure insurance for appellant, denied negligence by appellant, and denied that appellee's claimed loss was due to any negligence of appellee (R

7-10). As to appellee's second cause of action, such answer denied any agreement to procure insurance for appellee (R 10-12). By affirmative defense appellant alleged that the entire negotiation between appellee and appellant concerning proposed insurance for appellee was had by correspondence and sets forth such correspondence as exhibits numbered 1 through 9, both numbers inclusive, and alleges that there was no meeting of the minds of the parties, and no contract, and that appellant was not responsible to appellee for appellee's alleged loss (R 12-13). Exhibits numbered 1 through 9, above mentioned, were admitted as plaintiff's exhibits numbered 1 through 9 and are found at pages 166 through 175 of the record, except as to a printed form which is part of Exhibit No. 2 and which was admitted as defendant's Exhibit "B" and is found at pages 274 and 275 of the record. Plaintiff's exhibits also appear as follows: 1 (R 247), 2 (R 248-249), 3 (R 249-251), 4 (R 253), 5 (R 254), 6 (R 255-256), 7 (R 257), 8 (R 258), 9 (R 258-259), when they were read to the jury.

Appellee, as plaintiff replied to the affirmative matter in defendant's answer, admitting that exhibits one through nine attached to such answer represented correspondence between plaintiff and defendant, but for lack of sufficient information to form a belief denied that such exhibits constituted the entire correspondence between the parties as alleged in paragraph I of such affirmative defense. The reply denied the allegations of the second paragraph of the affirmative defense (R 16).

Jury trial of the matter was had. At the close of plaintiff's case, defendant moved for judgment on the ground that the evidence was insufficient to justify any judgment in favor of plaintiff and against defendant. At that time the Court held there was no contract between the parties (R 244;31), but that he would submit the matter to the jury upon the theory of negligence of the defendant in failing to procure insurance. After further argument on behalf of the defendant, based on the ground that there was no evidence of any duty owed to the plaintiff by the defendant and therefore there was nothing to go to the jury, the Court denied defendant's motion for dismissal.

Thereupon, defendant introduced testimony and at the close of all the evidence renewed his motion for dismissal, or in the alternative, for a directed verdict on behalf of the defendant. This motion was denied (R 35) and the matter was submitted to the jury on the theory of negligent breach of a duty by the defendant to procure insurance (Instruction of the court No. 2; R. 44). Verdict was for the plaintiff in the amount of \$9,200 (R 55). Judgment was rendered for the plaintiff and against the defendant as previously set forth.

Thereupon, on the first day of May, 1950, and within the period of time allowed by law and by the Federal Rules of Civil Procedure, defendant moved to set aside the verdict and the judgment and for judgment in favor of the defendant, or in the alternative, for a new trial (R 59-62). Both of these motions were de-

nied (R 65-66). Thereupon, this appeal was taken by defendant as appellant (R 66).

Appellee has taken no appeal from the judgment or any part thereof.

II.

STATEMENT OF THE CASE.

Plaintiff, Antonio Polimeni, at all times here in question resided at South Naknek, Alaska. At the same time defendant, Edward D. Coffey, resided at Anchorage, Alaska, and at all times here in question was admittedly an insurance agent and broker with offices at Anchorage.

Plaintiff Polimeni claims certain real property at South Naknek, Alaska, which in the spring and early summer of 1948 included a main building and two auxiliary buildings. The main building was a story-and-a-half of frame construction (R 73). This property was occupied by plaintiff prior to 1948. Just how he got it is in dispute. Whether he owned it is not clear (see Testimony of Witnesses, Smith R 92-97, 316-317; Polimeni, R 221, 307; Cuddy, R 312). In any event, after taking possession of the property, Polimeni did some work in repairing and remodeling the building upon the property and furnished certain labor and materials in such work. How much work was done and the cost of labor and materials doesn't appear, except as to deepening the well, which according to the testimony may have cost as much as \$300.00

(R 121). In any event, plaintiff opened a small restaurant on the property about March of 1948. At that time he had certain equipment and merchandise on the premises. The amount and value of that equipment and merchandise and supplies likewise is not clear from the record.

The facts concerning the relations between plaintiff and defendant as to insuring this property are not in dispute. The entire transaction between the parties was had by mail between South Naknek, Alaska, and Anchorage, Alaska, or vice versa, or by telegraph between the same points. Either the originals or proved copies of all of such letters and wires are before the Court as plaintiff's exhibits numbered one through nine and defendant's Exhibit "B".

Usual time for delivery of mail between South Naknek, Alaska, and Anchorage, Alaska, has not been directly proved but as will be seen from the record (R 247-258) it averaged about six to seven days during the period in question.

On March 30 of 1948 plaintiff wrote defendant from South Naknek, Alaska, inquiring concerning insurance on the property above mentioned and the equipment, stock, and supplies. This letter is plaintiff's Exhibit 1, set out at page 166 of the record. This letter was received at defendant's office on April 6, 1948 (R 247). To that inquiry defendant replied on April 9, 1948, quoting a rate for insurance and asking further information (Plaintiff's Exhibit 2, R 167) and enclosing a form (Defendant's Exhibit "B", R 273-274-275). Just when Mr. Polimeni received this

letter is not clear but in any event he answered it in part on April 17, 1948 (Plaintiff's Exhibit 3, R 168). This letter was received by defendant's office on April 24, 1948, but was mislaid until about July 23, 1948, and not answered until that date. Meanwhile, on June 1, 1948, plaintiff wrote defendant to learn what had happened to his application (Plaintiff's Exhibit 4, R 170-171), and defendant replied on June 4, 1948, to the effect he presumed his letter of April 9 had been lost and quoted that letter in full (Plaintiff's Exhibit 5, R 171-172). This letter was received by plaintiff about the middle of June, 1948, or a little sooner (R 238). Plaintiff didn't answer that letter. Neither did he answer the letter from defendant dated July 23 (Plaintiff's Exhibit 6, R 172).

The building described as the main building burned sometime in July, 1948. The date is not clear but is alleged to be July 20, 1948. No one who had actual knowledge of the time or the manner of the fire testified at the trial. Several witnesses testified that they knew the main building burned as they later saw the ashes.

Apparently, neither of the auxiliary buildings burned (Amended Complaint, First Cause of Action VII, Second Cause of Action V).

Plaintiff had left the vicinity a month to six weeks before the fire, leaving the place in the charge of witness Ruhl (R 128). Ruhl, in turn, left the place sometime before the fire and it was vacant at the time of the fire (R 228).

The matter was tried on the theory that in any event there must have been an agreement on the part of defendant to procure insurance for plaintiff before there would be liability of defendant to plaintiff whether the liability should arise as a result of negligence of defendant or as a breach of agreement by defendant. See Complaint, first cause of action, paragraphs III, V, and X (R 2, 3 and 4) and second cause of action, paragraphs I and II (R 4-5). See also comments of the Court concerning liability of defendant (R 144 near the bottom of the page and R 145 at the top of the page) and notice plaintiff's requested instruction number 1 (R 40).

The Court, as has previously been set out, specifically found that no agreement had been reached by the parties (R 31).

The defendant in the lower Court took the position that no agreement had been reached between the parties and that no liability existed from defendant to plaintiff, whether the action was based on a theory of damage resulting from alleged negligence or on alleged breach of contract, and further that in any event plaintiff knew more than a month before the fire that defendant had not procured insurance, and that any loss suffered by plaintiff was the result of his own actions. See answer, particularly affirmative defense (R 12, 13), various motions made for judgment or directed verdict or judgment for defendant (R 30, 32, 35, 59, 60-62, 244, 317), defendant's requested instructions to the jury (R 37-40).

III.

QUESTIONS INVOLVED.

1. Can defendant be held liable to plaintiff for damages allegedly suffered by plaintiff in the absence of a promise or agreement made by defendant to procure insurance for plaintiff?

2. Was defendant under any duty to act upon plaintiff's letter dated April 17, 1948?

3. Is defendant liable to plaintiff in this action even though it be assumed that defendant's employees were negligent in losing or mislaying plaintiff's letter dated April 17, 1948?

4. Was plaintiff's alleged loss the proximate result of the loss or misplacing of plaintiff's letter dated April 17, 1948, by defendant's employees?

5. Is plaintiff entitled to attempt to hold defendant liable for plaintiff's alleged loss on a theory of damage by negligence where it affirmatively appears that plaintiff knew more than a month prior to the alleged loss that defendant had not procured insurance for plaintiff and would not attempt to procure such insurance without further information from plaintiff?

6. On the record presented, is there any substantial evidence to support a judgment in favor of plaintiff and against defendant in the amount of \$9,200.

IV.

SPECIFICATIONS OF ERROR.

Appellant respectfully submits that the trial Court erred, and that each of such errors were substantial, and the results of those errors were prejudicial to defendant as follows:

1. That the trial Court erred in denying defendant's motion for judgment or for directed verdict in favor of defendant or for dismissal of the action as made at the close of plaintiff's case.

2. That the trial Court erred in denying defendant's motions made at the close of plaintiff's case as renewed at the close of all the evidence.

3. That the trial Court erred in submitting the matter to the jury at all.

4. That the trial Court erred in accepting the verdict of the jury.

5. That the trial Court erred in entering judgment in favor of plaintiff and against defendant in the amount of the verdict or at all.

6. That the trial Court erred in denying motion made by defendant to set aside the verdict and the judgment and in refusing to enter judgment in favor of defendant, notwithstanding the verdict.

7. That the trial Court erred in refusing to grant a new trial to the defendant.

V.

SUMMARY OF ARGUMENT.

1. Liability for alleged negligence presupposes a legal duty by one party to the other. This legal duty may arise by specific or implied agreement between the parties or by operation of law.

2. Defendant never at any time expressly or impliedly agreed to procure insurance for plaintiff as to the property concerned in this action.

3. Plaintiff's letter of April 17, 1948, was, at best, an application or proposal for defendant to secure certain insurance, and defendant was under no legal duty, either by specific or implied agreement or by operation of law, to accept or reject such application or to take any action upon it at all.

4. Since defendant was under no duty to accept or reject plaintiff's application or proposal for defendant to secure insurance for plaintiff, it becomes immaterial as to what defendant's employees did in connection with such proposal, and whether or not defendant's employees were negligent in handling such application or proposal is of no consequence in determining defendant's liability to plaintiff.

5. On the face of the record presented, plaintiff had ample time to procure or to attempt to procure insurance after he knew defendant did not intend to go further in the matter without additional information, and failed to act on the information he had either by furnishing the information requested by defendant or seeking insurance elsewhere. Accordingly, plaintiff is

in no position to blame his alleged loss on defendant or to claim damages of defendant.

6. Assuming for the purpose of argument, but for that purpose only, that there is liability of defendant to plaintiff, the record contains no substantial evidence to show the amount of plaintiff's loss or to support the verdict and the judgment following the verdict.

VI.

ARGUMENT.

At the outset appellant will concede that there is a line of cases holding insurance agents and brokers liable to applicants for insurance for negligent failure by the broker or agent to perform an agreement to procure insurance for the applicant or for negligence in performing an agreement to procure insurance. See 18 A.L.R. 1210 where it is said:

“It may be laid down as a general rule, that a broker or agent who, with a view to compensation for his services, *undertakes* (emphasis mine) to procure insurance on the property of another, and who fails to do so, will be liable for any damages resulting therefrom.”

See also the cases there digested and annotated.

The theory of those cases is that where one undertakes or agrees to procure insurance for another, and then, by reason of his own negligence, fails to procure such insurance, he is liable to the other party for the damages suffered by such other party up to the

limits of the policy which would have been in effect but for his negligence.

This line of cases and this theory was evidently followed by plaintiff in commencing this action and throughout the trial. Plaintiff's complaint is based on two alternative causes of action—one for alleged negligent failure of defendant to perform his alleged agreement to procure insurance for plaintiff, the other for breach of contract in failing to perform such agreement. The language used in alleging both causes of action shows conclusively that plaintiff was relying upon the rule herein mentioned for his recovery. That he pursued the same theory throughout the trial appears from plaintiff's requested instruction number 1 (R 40), which summarizes the theory and cites certain cases which follow that theory.

As will be seen from the excerpt above quoted from A.L.R. and from the cases there annotated, and also from plaintiff's requested instruction, liability of the agent or broker has been based upon the fact that he had undertaken or agreed to procure the insurance in question. Some of the cases go quite far to find an undertaking or agreement, but so far as the writer is aware none of the cases have found the broker or agent liable without finding some existing duty arising by contract, express or implied, to procure such insurance. In most of such cases the premium was paid at the time the agreement was made, but the writer has seen no case where the agent or broker has been held liable where the premium had not been paid or at least arranged.

The trial Court in this action specifically held (R 31, 244) that no agreement had been reached between the parties. A review of the record will demonstrate that that ruling was correct. The entire transaction was by correspondence. Plaintiff's first letter was an inquiry (R 166). Defendant's reply to that first letter answered the inquiry and set forth the information that would be required if an application for insurance were made (R 167). Plaintiff's reply to that letter was dated April 17, 1948, and is plaintiff's Exhibit 3 (R 168). It partially furnishes the information requested in defendant's previous letter and ends as follows:

"I trust this is the complete and necessary description for my insurance application."

It would seem that this letter itself is the application, although no specific request is made of defendant to attempt to procure such insurance. It is interesting to note that while plaintiff at that time knew the amount of insurance desired and the rate of the premium, he didn't send any money, he didn't make any arrangements to pay the premium, he didn't even mention premium.

This letter of application dated April 17 was admittedly lost or mislaid by defendant's employees for a period of over two months. The application or offer was never accepted. It seems clear that there was no agreement or undertaking by defendant to procure the insurance in question.

The trial Court, after holding that there was no agreement between the parties as to procurement of insurance, submitted the matter to the jury on a theory of negligence.

The elements of actionable negligence are set out in American Jurisprudence as follows:

“The primary wrong upon which a cause of action for negligence is based consists in the breach of a duty on the part of one person to protect another against injury, the proximate result of which is an injury to the person to whom the duty is owed. These elements of duty, breach, and injury are essentials of actionable negligence. In the absence of any of them, no cause of action for negligence will lie.”

38 Am. Jur., Negligence, Section 11, page 651, and cases there cited.

The element of a duty of one party to another in an action for tort based on negligence is discussed in American Jurisprudence as follows:

“An action to recover damages for an injury sustained by the plaintiff on the theory that they were caused by the negligence of the defendant will not lie unless it appears that there existed, at the time and place where the injury was inflicted, a duty on the part of the defendant and a corresponding right in the plaintiff for the protection of the latter. Negligence exists only with relation to a duty to exercise care. Actionable negligence is based upon the breach of a duty on the part of one person to exercise care to protect another against injury, by failing to perform, or

in the manner of performing, such duty, as a result of which the latter sustains an injury. Negligence is not a tort unless it results in the commission of a wrong, and the commission of a wrong imports the breach of a duty and a corresponding infringement of the right to be protected in person and in property.”

38 Am. Jur., Negligence, Section 12, page 652, and cases there cited.

See also discussion in American Jurisprudence on necessity of the injury being the result of a breach of duty.

“Clearly, the occurrence of an injury, without more, does not constitute a case of actionable negligence. A cause of action for negligence depends not only upon the defendant’s breach of duty to exercise care to avoid injury to the plaintiff, but also upon an injury suffered by the plaintiff as a consequence of the violation of duty.”

38 Am. Jur., Negligence, Section 27, page 672.

The above quotations are sufficient to illustrate that a party may not recover against another because of negligent acts or omissions of the other unless such other party was under a duty to act or not to act as the case may be.

Generally a person may be under a duty to act or not to act as a result of positive duty imposed by law, either as a result of statute or implication therefrom, or by reason of some special relationship between the parties or by reason of some agreement between the parties.

We have already shown that no agreement existed between the parties as to procuring the insurance in question. It has not been suggested that defendant was under any statutory obligation to act in the matter. As it appears from the record, there was no special relationship between the parties. Plaintiff first made inquiry and then applied for insurance. Defendant answered the inquiry and did nothing more. The parties were dealing at arm's length.

The record in this cause is entirely silent as to any duty of defendant to plaintiff, either by agreement or by operation of law. There is no suggestion made that defendant could not at his pleasure either accept or reject plaintiff's proposal that defendant attempt to secure insurance for plaintiff.

Generally speaking, silence or failure to reject an offer when it is made does not constitute an acceptance of the offer,

12 Am. Jur., Contracts, Section 40, page 533,
and cases there cited,

and an offer not accepted or rejected within a reasonable time is considered withdrawn.

12 Am. Jur., Contracts, Section 56, page 547.

The general law above cited is applicable to applications or proposals for insurance, and generally it is held that an insurance company is at liberty to choose its own risks and may accept or reject applicants as it may see fit.

American Life Insurance Co. v. Nabors, Texas, 1934, 124 Texas 221, 76 S.W. (2d) 497, 498.

It is a well-settled rule, established by the great weight of authority, that mere delay in passing on an application for insurance cannot be construed as an acceptance thereof by the insurer which will support an action in contract.

Schleip v. Commercial Casualty Insurance Co.,
Minnesota, 191 Minn. 479, 254 N.W. 618.

The cases here cited are merely illustrative of the principle involved and numerous other authorities could be cited to the same effect. Of course, it will be recognized that the cases cited involve insurance companies rather than agents or brokers. As has previously been shown, liability of a broker to the prospective insured is dependent upon a contract or agreement between the parties whereby the agent undertook to procure a policy for the prospective insured. Since mere inaction or delay on the part of an insurance company in accepting or rejecting a policy does not create an agreement to insure, it follows as a matter of course that like inaction or delay of an agent or broker in accepting or rejecting an offer that he procure insurance would not constitute an acceptance of the offer.

Plaintiff here tried this action upon the theory that defendant's employees were negligent in misplacing plaintiff's offer or proposal. That may be conceded as true for the purpose of this argument. It doesn't follow that such negligence raised any liability of defendant to plaintiff. The only effect of such negligence, if it was negligence, was that plaintiff's offer wasn't accepted within a reasonable time and

therefore could be considered as being withdrawn. Plaintiff was not bound by his offer at the expiration of a reasonable time after making it. He had a perfect right to apply elsewhere to attempt to get insurance. In fact, he had a positive duty to apply elsewhere if he wanted to attempt to get insurance. If he did not see fit to apply elsewhere, the loss which resulted is his own loss and he should not be allowed to shift the loss which resulted from his own inaction to some other party.

An attempt to allege an action in tort upon the facts shown by this record is an attempt to do by indirection what the law will not allow by direction. Defendant owed no duty at all to plaintiff to either accept or reject plaintiff's application. Inaction by defendant amounted to a rejection of plaintiff's offer. No contract resulted. No duty to act existed. No liability resulted. Whether or not defendant's employees negligently handled plaintiff's letter of application of April 17, 1948, is absolutely immaterial.

Zaye v. John Hancock Mut. Life Ins. Co. of Boston, Mass., Pennsylvania, 338 Penn. 426, 13 Atlantic (2d) 34.

At the close of plaintiff's evidence, the Court had already ruled that no contract existed between the parties. No evidence had been offered to support any contention of any duty existing from defendant to plaintiff. No dispute existed at to any facts concerning liability of defendant to plaintiff. No evidence had been presented concerning which the credibility of witnesses might be involved insofar as liability was

concerned. On the face of the record as presented, and as a matter of law, defendant was not liable to plaintiff. The trial Court should have dismissed the action at that point, or in the alternative should have directed a verdict in favor of defendant, or granted judgment in favor of defendant on defendant's motion. By the same token, the Court should have dismissed the action, or directed a verdict for defendant, or granted judgment for the defendant on his motion made at the close of the entire case. There was nothing to go to the jury. The Court should have held as a matter of law that defendant was not liable to plaintiff in any amount. Having allowed the matter to go to the jury, the Court should have refused to accept the verdict and should have rendered judgment for defendant upon defendant's motion for judgment notwithstanding the verdict.

It is apparent from the record here that plaintiff knew that no insurance policy had been issued. On June 1, 1948, he wrote a letter of inquiry asking whether there "are corrections to be made or what needs to be done." A few days later, and in any event prior to the middle of June, plaintiff received a letter from defendant in reply, which on the face of it showed that defendant believed he had not received an answer to his first letter dated April 9 and again asking for information as requested in that letter (R. 171; R. 238). Plaintiff on receiving that letter could have furnished the information or he could have gone elsewhere to seek insurance. If he saw fit to drop the matter, his loss, as a matter of law, is the proxi-

mate result of his own failure to act, not the proximate result of any negligence of defendant in mislaying the previous letter of April 17. The jury, on the evidence presented, could not properly find that plaintiff's loss was the proximate result of any negligence of defendant. The Court on that ground as well should have granted defendant's motions and taken the case from the jury and entered judgment for defendant.

Rule 50 of the Federal Rules of Civil Procedure provides as follows:

MOTION FOR A DIRECTED VERDICT

“(a) WHEN MADE: EFFECT. A party who moves for a directed verdict at the close of the evidence offered by an opponent may offer evidence in the event that the motion is not granted, without having reserved the right so to do and to the same extent as if the motion had not been made. A motion for a directed verdict which is not granted is not a waiver of trial by jury even though all parties to the action have moved for directed verdicts. A motion for a directed verdict shall state the specific grounds therefor.

“(b) RESERVATION OF DECISION ON MOTION. Whenever a motion for a directed verdict made at the close of all the evidence is denied or for any reason is not granted, the court is deemed to have submitted the action to the jury subject to a later determination of the legal questions raised by the motion. Within 10 days after the reception of a verdict, a party who has moved for a directed verdict may move to have the verdict and any judgment entered thereon set aside and to have

judgment entered in accordance with his motion for a directed verdict; or if a verdict was not returned such party, within 10 days after the jury has been discharged, may move for judgment in accordance with his motion for a directed verdict. A motion for a new trial may be joined with this motion, or a new trial may be prayed for in the alternative. If a verdict was returned the court may allow the judgment to stand or may reopen the judgment and either order a new trial or direct the entry of judgment as if the requested verdict had been directed. If no verdict was returned the court may direct the entry of judgment as if the requested verdict had been directed or may order a new trial."

Under the rule the trial Court should have entered judgment for the defendant. This Court, on reviewing the record, should reverse the trial Court with directions to the trial Court to enter judgment for defendant.

Eastern Livestock Cooperative Marketing Association v. Dickenson (C.C.A. 4), 107 F. (2d) 116;

Massachusetts Protective Assn., Inc. v. Moubert (C.C.A. 8), 110 F. (2d) 203;

U. S. v. Halliday (C.C.A. 4), 116 F. (2d) 812.

"When on the trial of the issues of fact in an action at law before a federal court and a jury, the evidence, with all the inferences that justifiably could be drawn from it does not constitute a sufficient basis for a verdict for the plaintiff or the defendant, as the case may be, so that such a

verdict, if returned, would have to be set aside, the court may and should direct a verdict for the other party.

“A mere scintilla of evidence is not enough to require the submission of an issue to the jury. The decisions establish a more reasonable rule that in every case, before the evidence is left to the jury, there is a preliminary question for the judge, not whether there is literally no evidence, but whether there is any upon which a jury can properly proceed to find a verdict for the party producing it, upon whom the onus of proof is imposed.”

Gunning v. Cooley, 281 U. S. 90;

Indemnity Insurance Co. of North America v. Atchison, T. & S.F. Ry. Co. (C.C.A. 9), 85 F. (2d) 438.

Defendant has always maintained and still maintains that he is not liable to plaintiff at all. However, for the purpose of this argument, and for that purpose alone, defendant submits that there is in the record no satisfactory evidence of plaintiff's loss or the amount thereof. As to the building, it is purely speculative as to whether plaintiff had any interest therein except bare occupancy. The facts certainly are in plaintiff's knowledge and the knowledge of his witnesses and of witnesses he could have produced. The burden is upon plaintiff to prove his damages as well as the other material allegations of his complaint. Instead of proving that he had some insurable interest in the building, he and his witnesses evaded the issue at every turn. The best that can be made from the

evidence is that plaintiff purchased the building from the former United States Commissioner for a sum of twelve hundred dollars, of which an unspecified amount was paid and the rest cancelled. It seems quite likely that the building belonged to a deceased person whose estate had not been probated. If that were not true, plaintiff could certainly have produced testimony to rebut the evidence of defendant's witness, Cuddy, on that point. The only evidence he offered on that point is found in the direct examination of plaintiff's witness, Smith, at page 317 of the record.

Question by Mr. Nesbett, plaintiff's attorney:

"And do you know whether or not the Heinz Smchhook Estate had any interest in this property which later became Tony's?"

Answer:

"I don't know positively."

Certainly it would seem likely that the witness at least had a very strong suspicion that the building did belong to the Estate of Heinz Smchhook and not to the plaintiff at all.

Several witnesses testified that plaintiff improved the building. It would seem that if in fact he improved someone else's building that he has no claim for loss of such improvements. In any event no testimony was offered as to the value of either the labor or materials that went into improving the building (R. 221).

It appears from the record that plaintiff wanted all three buildings insured together for \$6,000. Only one

building burned. There is no evidence in the record at all concerning the value of the buildings which didn't burn.

Plaintiff had some equipment in the building. Whether it was still there when the building burned is not known. At least two weeks elapsed after Ruhl left and before the building burned. In testifying as to the equipment and as to the inventory and stock, the witnesses were handed the bill of particulars furnished by plaintiff just before trial. Who made up that bill of particulars or from what it was made isn't clear. Certainly it was not identified as an exhibit. The best that can be made from the testimony is that each of the witnesses knew some of the equipment was in the place at some time, but no one knows what was there at the time of the fire. It is entirely possible that all equipment and stock was removed before the fire. According to the application, the light plant was in a separate building which didn't burn. Now it is claimed the light plant was on the porch of the main building. It is an even bet that gasoline or waste from such engine caused the fire, but of course there is no evidence on that. However, it seems questionable, at best, as to whether a policy, if issued, would have covered the value of that light plant at a location in the main building. The value of that light plant is lumped in plaintiff's claimed loss.

There is no real evidence as to what merchandise or stock Polimeni ever had. The inventory on the bill of particulars was never explained as to where and how and from what information it was compiled. It seems

probable that at least a large part of plaintiff's supplies were used by Ruhl after plaintiff left the place. In any event, no one testified that the merchandise listed on the bill of particulars was in the place when it burned. It is entirely possible it had been removed before the fire.

Certainly plaintiff could have produced real evidence as to what he lost and its value. It seems to the writer that the only possible reason for his refusal to produce inventories, and to produce as witnesses persons who knew the facts, and for his evasions when defendant attempted to learn these values, is because he knew that his real loss was only a fraction of his claimed loss.

The state of the record as to proof of damage is such that there was no substantial evidence as to the amount of plaintiff's loss, if any. Under the record the jury could do nothing except to speculate as to the amount of plaintiff's loss, if any.

The Court should have directed a verdict for the defendant on the ground that plaintiff had not proved his damages. It is apparent from the record that there is no evidence to support a verdict for \$9,200. There is no possible formula by which that figure could have been reached under the evidence introduced.

Having allowed the matter to go to the jury, the trial Court should have granted defendant's motion for new trial for the reason that the verdict is certainly not supported by the evidence as to the amount

of damage, if for no other reason. Appellant believes the trial Court abused its discretion by failing to grant such motion.

Motion for new trial is not waived by motion for judgment, notwithstanding the verdict or the action of the Court thereon.

Montgomery Ward and Company v. Duncan,
311 U.S. 243.

Appellant respectfully submits that for the reasons here shown that there is no liability of defendant to plaintiff and that the trial Court committed substantial error prejudicial to appellant in denying motions made by appellant as defendant as herein set out, and in submitting the matter to the jury, and in accepting the verdict and entering judgment for plaintiff and against defendant, and in failing to vacate the verdict and judgment, and in failing to enter judgment for defendant, or in the alternative, in refusing to grant a new trial.

Appellant respectfully submits that the action of the trial Court should be reversed and that the trial Court should be directed to enter judgment for the defendant.

Dated, Anchorage, Alaska,
January 19, 1951.

Respectfully submitted,

DAVIS & RENFREW,

By EDWARD V. DAVIS,

Attorneys for Appellant.

No. 12,659

United States Court of Appeals
For the Ninth Circuit

EDWARD D. COFFEY,

VS.

ANTONIO POLIMENI,

Appellant,

Appellee.

BRIEF FOR APPELLEE.

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FILED

MAY - 2 1951

PAUL F. O'BRIEN,
CLERK

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No. 12,659

United States Court of Appeals
For the Ninth Circuit

EDWARD D. COFFEY,

VS.

ANTONIO POLIMENI,

Appellant,

Appellee.

BRIEF FOR APPELLEE.

STATEMENT OF THE CASE.

Plaintiff, Antonio Polimeni, during and for more than thirty years prior to the times involved herein had been a resident of South Naknek, Alaska. The defendant Edward D. Coffey maintained an insurance office at Anchorage, Alaska, and acted as agent and broker for at least fifteen different insurance companies (Tr. 146). Coffey had, in previous years, acted as agent for Polimeni in procuring insurance on real property and an airplane (Tr. 240-241).

On March 30, 1948, Polimeni wrote to Coffey requesting information concerning insurance on his restaurant building, equipment, supplies and beer and wine supply (Tr. 166; Plaintiff's Ex. 1).

On April 9, 1948, Coffey replied, quoting a rate for such insurance and requesting a description of the location of the property, distance from post office or public school building and requesting type of construction and occupancy of any buildings within 100 feet of the restaurant to be insured (Tr. 167-8; Plaintiff's Ex. 2).

On April 17, 1948, Polimeni replied to Coffey as follows:

“Plaintiff's Exhibit No. 3

South Naknek, Alaska

April 17, 1948.

Edward D. Coffey,
Anchorage, Alaska

Dear Sir:

Having received your reply to my inquiry concerning my insurance, I am supplying necessary description of the property and equipment.

The main restaurant building is (1000') one thousand feet from the South Naknek Territorial School Building and approximately (300') three hundred feet from the post office.

1. Main Building: 30'-30'

Restaurant—two story building housing booths, counter, kitchen, pastry room, laundry on the first floor, with five rooms on second floor for living quarters for owner and hired assistants, and basement (18'-20') eighteen by twenty feet providing storage capacity for restaurant supplies and special compart-

ment for automatic pump connected to the well inclosed within the building with descent from kitchen. Attached to kitchen and pertaining to service thereof are kitchen range, hot and cold water, tank, and sink.

2. 8'-10' building 50' from main building

This building is used for housing light plant providing electrical power for restaurant and used as a repair shop.

3. 6'-8' 20 feet from main building

Separate restrooms with shields for entrances. These buildings mentioned have tin roofs and are to be insured en masse for (\$6,000.00) six thousand dollars.

Equipment and Supplies

Furniture:

Five beds complete with all season bedding, three wardrobe bureaus with clothing of owner and assistant, six chairs, two tables, one sewing machine, and one phonograph (electric).

Fixtures:

Washing machine, electric iron, complete line of China and silverware for serving one hundred capacity, and bowls, platters, and beer and wine glasses.

Machinery:

Gasoline engine, automatic water pump, 8 K.W. light plant.

The furniture, fixtures, and machinery are to be insured for (\$1,500.00) fifteen hundred dollars.

Stock:

Complete line of food supplies for restaurant operation for six months including small amounts of beer and wine. The stock is to be insured for (\$2,500.00) two thousand five hundred dollars.

I trust this is the complete and necessary description for my insurance application.

Thank you,

Sincerely,

/s/ Antonio Polimeni

Received April 24, 1949." (Tr. 168; Plaintiff's Ex. 3.)

Polimeni's letter of April 17th was received by Coffey on April 24, 1948, read by Grace McConnell, Coffey's office manager (Tr. 249 and 289), and given by her to the fire insurance girl in Coffey's office to write Polimeni for a breakdown on the amount of insurance desired on each of the buildings. Polimeni's letter was lost or misplaced by the fire insurance girl and not found for 62 days (Tr. 290). The letter had never been referred to Coffey himself (Tr. 291) and in the ordinary course of office routine the fire insurance girl would have signed the reply. Neither Coffey nor his office manager maintained a check-off method to determine whether the fire insurance girl carried out her instructions in such instances (Tr. 293 and 295).

No reply having been received to his letter of April 17, 1948, Polimeni wrote to Coffey as follows on June 1, 1948:

"Plaintiff's Exhibit No. 4

So. Naknek, Alaska

June 1, 1948

Ed. Coffey,
Anchorage, Alaska

Dear Mr. Coffey:

I have written you before concerning my insurance for my restaurant and I have received no reply.

I would like to hear from you immediately and learn the particulars and premium of the policy. Are there corrections to be made or what needs to be done?

Please reply immediately.

Thank you.

Sincerely,

/s/ Antonio Polimeni." (Tr. 170; Plaintiff's Ex. 4.)

This letter was received and read by Grace McConnell, Coffey's office manager, who remembered Polimeni's letter of April 17th. McConnell asked for the letter, but it could not be found (Tr. 297). A search was conducted for not more than one day without success (Tr. 297) whereupon search was discontinued and McConnell instructed the fire insurance girl to write to Polimeni and "get the information again". (Tr. 297). As a result, the following letter was written:

“June 4, 1948.

Mr. Antonio Polimeni,
South Naknek, Alaska.

Dr. Mr. Polimeni:

Re: Fire Insurance on Building occupied as Restaurant & Dwg.

We are in receipt of your letter of June 1st in regard to your insurance. We wrote you the following letter, mailed April 9, 1948, but evidently it was lost, so we will quote same:

‘In reply to your letter of March 30th wish to advise that the fire insurance rate on both building and contents is \$3.00 per \$100 of insurance for one year.

‘It is necessary to place a specific amount of Insurance on the building and a specific amount on equipment and supplies. Beer and wine would be insured under stock. We enclose form which indicates how the insurance is divided.

‘If insurance is ordered, we will need to have a description of the location of the property. If the land is unsurveyed so you cannot give us lot and block numbers, please advise how far distant your building is from the Post Office or the Public School Building. Also advise the construction and occupancy of any buildings within 100 feet of your building.’

We trust that this is the information you desire.

Yours very truly,

Edw. D. Coffey”

(Tr. 171; Plaintiff’s Ex. 5.)

The testimony does not indicate whether Polimeni ever received this letter (Tr. 140 and 238). Polimeni left the restaurant in the charge of Albert Ruhl and went fishing for king salmon on the 10th or 15th of June, 1948 (Tr. 128). Ruhl closed the restaurant down two weeks later and went fishing himself (Tr. 128). After going fishing Ruhl made it a practice to check the restaurant when back in South Naknek between fishing trips, approximately once a week and on or about July 20, 1948, while unoccupied, the main building, equipment and stock were completely destroyed by fire (Tr. 124-125) while Ruhl and Polimeni were on fishing grounds.

On July 23, 1948, Coffey wrote the following letter to Polimeni:

“Plaintiff’s Exhibit No. 6

Edward D. Coffey
General Insurance
Anchorage, Alaska

July 23, 1948.

Mr. Antonio Polimeni,
South Naknek, Alaska

Dear Mr. Polimeni:

Re: Fire Insurance on Building occupied as
Restaurant and Dwg.

We wish to apologize for having mislaid your letter of April 17 giving us the details of the property you wish to have insured. We enclose herewith copy of your letter for reference as we need the following breakdown before we can issue policies:

Building No. 1.—Please designate a specific amount on the building and a specific amount on the equipment.

Building No. 2.—Specific amount on building.

Building No. 3.—Specific amount on building and specific amount on 8 K.W. light plant.

We assume the stock of food supplies is contained within the restaurant and no other building.

Will you kindly give us this information so we may issue your policies.

Very truly yours,

Edw. D. Coffey,

By /s/ M. Kaser."

(Tr. 172; Plaintiff's Ex. 6.)

On August 2, 1948, Polimeni, through Hal M. Marchbanks, U. S. Commissioner at Naknek, informed Coffey of the loss (Tr. 173; Plaintiff's Ex. 7) and Coffey telegraphed his reply stating that no insurance was in effect (Tr. 174; Plaintiff's Ex. 8).

The testimony shows that Polimeni acquired the restaurant building in 1945 and during the following three years practically rebuilt it from monies earned by him as a fisherman (Tr. 73). Rebuilding consisted of tearing off the original roof and rebuilding it with gables to create five rooms upstairs (Tr. 120); all new windows were installed, plywood partitions installed, new doors and locks; the well was dug down to 60 feet, cased, and automatic electric pump installed. The basement was enlarged, steps installed and walls finished off with redwood and all nine rooms were

insulated and finished with masonite. The value of the building, equipment and inventory was between \$13,000 and \$16,000.

Plaintiff's first cause of action is based upon defendant's negligence in misplacing plaintiff's letter of April 17, 1948 and thereby failing to insure the property (Tr. 3). His second cause of action is based upon defendant's breach of contract to procure insurance (Tr. 4-5).

Upon conclusion of plaintiff's case the Court ruled that the evidence was insufficient to support the cause of action in contract (Tr. 31) and refused to reconsider this ruling later in the case when plaintiff made an offer of proof of newly discovered evidence (Tr. 319) in support of the contract theory.

The trial proceeded on the negligence theory and went to the jury and verdict returned in favor of plaintiff in the sum of \$9,200 (Tr. 55). The jury obviously deducted \$300 as the cost of premium had insurance been duly procured and \$500 as the value of the two buildings not destroyed by fire (Instr. No. 9; Tr. 47).

ARGUMENT.

As conceded at the beginning of the argument in appellant's brief, there is a line of cases holding insurance agents and brokers liable for negligent failure to procure insurance for an applicant.

This doctrine, as far as our Courts are concerned, appears to have developed from *Morris v. Sumerl*,

C. C. Dist. Penn. 1808, Fed. Case 9,837, where the Court said that if one merchant is in the habit of effecting insurance for another and neglects to have same done when ordered, he is himself answerable for the loss. The jury was so instructed. The Court said:

“If he can excuse himself for not having effected the insurance, he is answerable for nothing; if he cannot, he is then answerable for the whole.”

The doctrine was again applied in *Manny v. Dunlap*, Cir. Ct. Iowa 1869, Fed. Case 9,047 where plaintiff's agent failed to procure insurance as directed and the Court held that an agent to procure insurance, when he has undertaken, or it has become his duty to insure, and without good reason he has neglected to do so, he is liable for all loss which may occur, that would have been covered by the policy. Citing *Morris v. Sumerl*, supra.

In 1897 in Hawaii in *Mary S. Carter et al. v. Manhattan Life Ins. Co.*, 11 Hawaii 69, an agent, for no good reason, retained a life insurance application from November 12, 1944 until January 5, 1895 before forwarding. The Court held:

“A life insurance company is liable for the negligence of its agent in failing to forward an application for insurance within a reasonable time, and if in consequence of such negligence the application is not accepted prior to death of applicant, and if it would have been accepted prior thereto but for such negligence, the measure of damages is the amount for which the policy would have been issued.”

In *Boyce v. Union Dime Loan Assn.*, S/C Penn. 1907, 67 A. 767, a mortgagee, for his own advantage, agreed to insure and collect from mortgagor, but in insuring, misdescribed the property. After loss, mortgagee was held liable in damages on *assumpsit*, but the Court said it was immaterial whether mortgagee was charged as an insurer or as guilty of negligence in not effecting proper insurance, citing *Manny v. Dunlap*, *supra*.

In *Wilkin et al. v. Capital Fire Insurance Co. of Lincoln, Neb.*, 1916, 99 Neb. 828, 157 N.W. 1021, an agent of insurance company sent application to a bank to be executed—applicants signed and left with bank to return—bank failed to return for ten days—loss by fire. The Court held that the delay of the bank in forwarding application must be considered the delay of the agent, for which the insurance company was responsible and *that the question of the liability of the insurance company for failure to duly act upon the application was for the jury*. (Emphasis supplied).

In *Rezac v. Zima*, Kan. 1915, 153 Pac. 500, it was held that where a broker or agent undertakes to procure insurance for another, he is bound to exercise reasonable diligence to obtain it and give timely notice to his principal in case he is unable to *procure it and any loss resulting from inattention, incapacity or fraud makes him liable*. (Emphasis supplied).

See also the following cases to same effect: *Boyer v. State Farmers Mutual Hail Ins. Co.*, 86 Kan. 442, 121 Pac. 329; *Harrod v. Latham*, Kan., 95 Pac. 11;

Wallace v. Hartford Fire Ins. Co., Idaho 1918, 174 Pac. 1009; *Security Ins. Co. of New Haven, Conn. v. Cameron et al.*, Okla. 1922, 205 Pac. 151; *Stark v. Pioneer Casualty Co. et al.*, Calif. 1934, D.C.A. 2nd Dist., Div. 2, 34 Pac. (2d) 731, hearing denied by S/C Sept. 4, 1934; *Elam v. Smithdeal Realty*, N. Car. 1921, 109 S.E. 632; *Mayhew v. Glazier et al.*, Colo. 1920, 189 Pac. 843; *Lindsay v. Pettigrew*, S.D., 59 N.W. 726.

On pages 15, 16 and 17 of his brief appellant has cited American Jurisprudence on Negligence and Contracts in General, but has failed to cite American Jurisprudence on the specific point here involved. See 29 Am. Jur., Insurance, Sec. 108, p. 130 as follows:

“Failure to Procure or Maintain Insurance—It may be laid down as a general rule that a broker or agent who, with a view to compensation for his services, undertakes to procure insurance on the property of another, and, unjustifiably and through his fault or neglect, fails to do so, will be held liable for any damage resulting therefrom * * * it is generally accepted that the undertaking in itself imposes a duty to procure such insurance, and according to some authorities, the trust and confidence imposed in a broker employed to secure insurance on property afford a sufficient consideration for his undertaking to carry out the instructions given.”

On page 17 of his brief appellant cites *American Life Insurance Co. v. Nabors*, Tex. 1934, 76 S.W. (2d) 497, 498 in support of the proposition that an insurance company is at liberty to choose its own risks,

and may accept or reject applicants as it may see fit. It is to be noted that this case concerned an *application for life insurance*, and in such cases the application specifically states that the contract of insurance is not in effect until the application has been accepted by the company. Such holdings are understandable as it is common knowledge that reports of medical examination and family medical history are almost always forwarded with the application and closely scrutinized by insurance company doctors. Nevertheless the Courts have held in many life insurance cases that negligent failure to either accept or reject the application will make the company liable if the application would have been accepted in the ordinary course of business except for inexcusable delay.

In direct contrast to the life insurance cases supporting appellant's theory are the cases involving fire, hail, casualty insurance, etc., where the agent of such insuring companies can ordinarily effect an immediate oral contract of insurance on such risks, with or without the use of a "binder" notation. 29 Am. Jur., Insurance, Sec. 135, p. 151 and such contracts of insurance are binding upon the company *until rejected by the company*, in contrast with life insurance applications that do not create a contract until accepted by the company of the agent.

The facts in this case clearly show a negligent failure on the part of Coffey to procure insurance after undertaking to do so. Coffey had acted as broker or agent for Polimeni on two occasions prior to the present case; once for insurance on a house in Egegik, Alaska (Tr. 240) and for insurance on an airplane

(Tr. 242). In Polimeni's offer of proof (Tr. 319), evidence was offered to prove that Polimeni had discussed insurance on the restaurant building involved herein, in Coffey's office in Anchorage in late 1947 or early in 1948; that Coffey agreed to procure insurance on the building when Polimeni was ready, after completion of the building and inventory.

Coffey represented at least fifteen insurance companies (Tr. 146), advertised extensively "Coffey Insures Everything—Remember?" (Tr. 207). Polimeni was an almost illiterate Italian fisherman and cook, with a speech impediment, and hardly able to write (Tr. 84), who had his correspondence prepared by the South Naknek school teacher and friends (Tr. 132). Having been served by Coffey on at least two previous occasions and having been advised by Coffey that he would insure the buildings and stock involved herein it was natural for Polimeni to cause the letter of March 30, 1948 to be written to Coffey (Plaintiff's Ex. No. 1; Tr. 166). It is interesting to note that Coffey's reply (Plaintiff's Ex. 2; Tr. 167) states that "if insurance is ordered" certain information must be supplied, etc., and to observe in Polimeni's prompt reply of April 17, 1948 (Plaintiff's Ex. No. 3; Tr. 168) that all the information required by Coffey "if insurance is ordered" is supplied in the greatest of detail. This letter was received by Coffey on April 24, 1948, read by Grace McConnell (Tr. 289) and given by her to the fire insurance girl without reference to Coffey himself. The fire insurance girl was instructed to write to Polimeni to obtain a breakdown on how the building insurance was to be divided between the main

building, the two-holer outhouse, and the generator house (Tr. 293). The letter was lost in the office confusion and not found until July 23, 1948, 62 days later (Tr. 290). *No person in Coffey's office knew the letter was lost until Polimeni's letter of June 1, 1948, was received* (Plaintiff's Ex. No. 4; Tr. 170). The reason no one in Coffey's office knew the letter was lost was because no part of the correspondence was ever referred to Coffey (Tr. 290), Grace McConnell feeling that she was "perfectly capable of handling it myself" and according to her own personal underwriting policy (Tr. 291).

Under Coffey's office routine, the fire insurance girl should have written the letter to Polimeni, signed it herself, and turned it over to the mail girl (Tr. 295). *Neither Coffey nor Grace McConnell would have seen the reply, if one had been written, and neither Coffey nor McConnell maintained a check-off system to determine whether the fire insurance girl carried out instructions in such situations* (Tr. 295). And the fire insurance girl lost the letter of April 17 and forgot about it. No one in Coffey's office realized it was lost because of the lack of any system whatever for handling such matters.

After receiving Polimeni's inquiry of June 1, 1948, saying in part "I would like to hear from you immediately to learn the particulars and premium of the policy * * * Please reply immediately * * *" (Tr. 170-171). Grace McConnell caused a short unsuccessful search to be made in the office for the letter of April 17th, *which she remembered* (Tr. 297). No

other attempt was made to locate the missing letter and the matter was forgotten on the assumption that sooner or later Polimeni would send the information again (Tr. 298). In directing the fire insurance girl to ask for the information again, McConnell failed to tell the fire insurance girl to ask Polimeni to segregate the amount among the three buildings (Tr. 298).

McConnell did not keep the Polimeni file on her desk to remind her to look for the missing letter again (Tr. 298).

No attempt whatever was made to obtain coverage on Polimeni's property before the letter of April 17th was lost.

Appellant contends on page 21 of his brief, that Polimeni's failure to answer Coffey's letter of June 4, 1948 (Plaintiff's Ex. No. 5; Tr. 171) amounted in effect to contributory negligence. This contention amounts only to an argument with the verdict of the jury which had placed before it the question of contributory negligence in Instruction No. 8 (Tr. 47) and the question of whether or not Coffey's delay was the proximate cause of Polimeni's loss in Instructions Nos. 4, 5, and 6 (Tr. 45-46).

Coffey was not only negligent in misplacing or losing Polimeni's letter of April 17th, but was, according to the general custom in the insurance world, negligent again in failing to place insurance on Polimeni's property immediately upon receipt of the letter of April 17th.

Joseph Sheahan, a witness at this trial, testified that he was engaged in the insurance business in Anchor-

age, Alaska; that he had been in the insurance business for 32 years; *that he had worked for Coffey for over a year, terminating on January 22, 1948, just three months before Coffey received Polimeni's letter of April 17th* (Tr. 160-161). Sheahan was subpoenaed as a witness. On page 184 and following of the transcript the following questions and answers are reported (direct examination of Mr. Sheahan by Mr. Nesbett):

“Q. You testified did you not that your association with Mr. Coffey terminated on January 22nd, 1948?

A. That is right.

Q. Now, Mr. Sheahan, if you had received that letter of April 17th on January 21st of 1948, while you were still associated with Mr. Coffey, could you through Mr. Coffey's companies have effected a ten thousand dollar coverage on Mr. Polimeni's restaurant?

* * * irrelevant * * *

A. Yes. I would have put twenty-five hundred dollars, or perhaps fifteen hundred in an American Company and wired to Lloyd's in Seattle.

Q. In Seattle?

A. For the balance.

Q. Would you have requested telegraphic confirmation, Mr. Sheahan, as a general practice?

A. Yes. Oh, yes, they wire right back, usually the next day.

Q. Mr. Sheahan, what is the practice, or what was the practice in Mr. Coffey's office with respect to telegraphic requests and telegraphic confirmations as of January 22nd, when you terminated?

A. We telegraphed for coverage. We would ask for a reply immediately. Confirmation in other words."

Then on page 187 the following transpired:

"Q. We were discussing the letter of April 17th, containing that information. I asked you what the agent would have done on receipt of that letter in the usual course of business.

A. He would have bound the coverage right then, but written exactly the same letter he did, asking how much insurance he wanted on each building.

Q. Then Mr. Polimeni would have been covered at the time the agent wired and placed part of the request on the warranty company?

A. That is right.

Q. You could have done that on January 21st under the usual procedure and the authority of Mr. Coffey's position could you not?

A. I hate to say it, but I could have, yes."

Commencing on page 189 of the transcript, while Mr. Sheahan was being cross-examined by Mr. Renfrew the following transpired:

"Q. Now, to get down to this case, Mr. Sheahan, I believe you testified that upon receipt of the letter of April 17, which you have looked at and which is the letter purporting to give the information upon which the insurance was to be written, that you could have covered the prospective customer by writing him and telling him how much you would cover him and then asking how much insurance he wanted on each building.

A. I would have wired him.

Q. That would have been a matter of just your personal way of doing business?

A. If a man wants insurance, he wants it right now, and you might just as well wire, I think.

Q. Actually you could not have bound that insurance without further information?

A. Yes, I could have bound it and then asked him for the information.

Q. Now then, there are three buildings involved in that application of April 17th. Supposing you say you are bound, Mr. Polimeni, but I have to know how much you want on each building.

A. That is what I would have done.

Q. Before he could answer this, the main building burned down. How much would you pay out?

A. The actual value of the building.

Q. But you haven't any contract with him at that time?

A. No.

Q. Do you think your company would have been bound if you had wired?

A. Yes, I do, and furthermore you once came from Naknek and you said you wanted some insurance for somebody down there and I said 'it is covered'.

Q. That is very possible. I don't remember it. But were they covered?

A. They were covered if I said so."

And again on page 192:

"Q. You say back in January, 1948, while you were still in the employ of Mr. Coffey, you would have and could have bound Mr. Polimeni from the informa-

tion contained in the letter of April 17th. Will you state by virtue of what authority as a salesman for Mr. Coffey that you could have bound \$10,000 on one risk and one company he had authority to bind?

A. I would have put that in four companies. That is, the \$2500, and using that company as a warranty company I would have wired Lloyd's and asked them to cover the other \$7500.

Q. These four companies you would have bound in in the amounts of \$2500, assuming now that you know and you are testifying from your personal knowledge of the company, what companies would Mr. Coffey have the authority to bind an unprotected risk in, even \$2500, on January 21st?

A. I say fifteen hundred or twenty-five hundred.

Q. What four companies?

A. Let's make it twenty-five hundred. Philadelphia Fire & Marine, Canadian Fire, The General Insurance Company of America, Fidelity and Guaranty Fire. There's four.

Q. Is it your testimony that when you left there in January that the Philadelphia Fire Insurance—that Mr. Coffey had binding authority, that he could have bound them to the tune of \$2500 on an unprotected risk in Naknek?

A. I think so. One of the four would have taken \$2500 and that is all we need to wire Lloyd's.

Q. One of the four?

A. Yes.

Q. Would you have told Mr. Polimeni that he was bound without finding out which one of the four would have taken it?

A. I would have known at that time. It has been quite a while since I have been there. I would have known then which company would take it.

Q. What you are testifying now to is that he had at least four companies and you are sure one of them would have taken an unprotected risk, but you don't know which one?

A. He had more than four."

The attention of the Court is invited to the fact that the only time that the defendant, Coffey, took the witness stand was when he was called as an adverse witness by plaintiff's attorneys. The defendant Coffey failed to take the stand in rebuttal in connection with any of the testimony of the witness Joseph Sheahan. The witness Grace McConnell, Coffey's office manager, upon cross-examination, finally admitted that it would have been possible to place \$1500 or \$2500 on unprotected property with one of the companies represented by Coffey and that she could have wired Seattle to obtain the balance of the insurance with Lloyd's, but preferred not to do so by reason of her own private underwriting policies.

Appellant contends that there is no substantial evidence to support a judgment in favor of plaintiff and against defendant in the sum of nine thousand two hundred dollars.

On page 46 of his brief appellant says:

"Certainly plaintiff could have produced real evidence as to what he lost and its value."

In this connection the attention of the Court is invited to Polimeni's letter of April 17, 1948 (Plain-

tiff's Ex. No. 3; Tr. 168) which sets out in general the type buildings to be insured and equipment and inventory; and too, a bill of particulars furnished by plaintiff which itemizes the inventory (Tr. 20); to the testimony of Albert Ruhl commencing at page 122 of the transcript; and to the testimony of Bill Smith commencing on page 74 of the transcript.

CONCLUSION.

In conclusion it is submitted that at the trial of this case plaintiff proved conclusively that the defendant Coffey was negligent in failing to maintain any semblance of office routine to prevent the loss of a document as important as plaintiff's letter of April 17, 1948; that the defendant's office manager was negligent in failing to institute a more thorough search for the letter after she learned it was lost in her office; that she was negligent in failing to refer the matter to Mr. Coffey himself; that failure to place coverage on the property immediately upon receipt of the letter of April 17th, by the methods outlined in the testimony of Joseph Sheahan amounts to negligence. All of the above mentioned questions were fairly placed before the jury and their finding should not be disturbed.

Polimeni had made no attempt to procure insurance elsewhere (Tr. 225).

By reason of prior business transactions with the defendant, plaintiff relied on the defendant's business ability, initiative and efficiency with the result that the

property he had spent the last years of his old age acquiring was completely destroyed by fire without coverage.

Dated, Anchorage, Alaska,
March 2, 1951.

Respectfully submitted,
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No. 12,659

United States Court of Appeals
For the Ninth Circuit

EDWARD COFFEY,

VS.

ANTONIO POLIMENI,

Appellant,

Appellee.

APPELLANT'S REPLY BRIEF.

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For the Ninth Circuit**

EDWARD COFFEY,

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Appellant,

Appellee.

APPELLANT'S REPLY BRIEF.

PRELIMINARY STATEMENT.

In our opening brief we contended that even if defendant were negligent he was entitled to judgment as a matter of law because an action does not lie for mere delay in acting on an insurance application, there being no legal duty which is breached. We recognized that there is a conflict of authority on the point but we maintained that the sound rule is the one which denies a right of action. We also contended that the doctrine which affirmed such a cause of action appeared to be limited to cases in which the premium had been paid or arranged for, which was not done in the case at bar; furthermore that the trial court found no contract in this case, and thereby cut off the alleged basis for defendant's obligation; and

finally that the sole cause of plaintiff's loss in this case was his own inaction after he had learned by defendant's letter of June 4th that defendant would do nothing in the absence of further information.

We think that the last mentioned point is so clearly decisive that it alone disposes of the case without reference to the other points including the general question whether such an action ever lies. However, since appellee has cited a number of authorities on the latter question, we are moved to respond to them.

Our position, therefore, is this:

First, that the sound doctrine is that there is no liability for delay in acting on an insurance application;

Secondly, that even if the authorities which uphold such liability were to prevail, for the reasons stated they would not sustain the judgment in favor of plaintiff in this case.

Within the framework of these contentions we will respond to the arguments in appellee's brief.

I.

THE SOUND DOCTRINE IS THAT THERE IS NO RIGHT OF ACTION FOR DELAY IN ACTING ON AN INSURANCE APPLICATION.

It must be remembered that we are speaking of the liability of an agent for the insurance company, not an agent for the applicant. Obviously, there is a fundamental difference between the situation on the

one hand of an agent who fails to carry out the task which he agreed to perform for his principal, who is an applicant for insurance, and the situation on the other hand of an agent for the insurance company who stands at arm's length toward the applicant.¹

There are cases which hold that where an agent for an insurance company receives an application for insurance and delays forwarding it to the company, and the risk was actually acceptable but remained uninsured because of the agent's delay, the insurance company may be held liable in tort to the applicant for damages for failure to insure.² The right of action is not based on the contract, because no such contract exists, but it is based on the negligence which prevented the contract from coming into being.

¹Appellee states that appellant had acted as broker or agent for appellee on two prior occasions (Brief for Appellee, p. 13). If the object is to intimate that appellant was agent for appellee in this transaction, it fails. The portions of the transcript referred to (pp. 240, 242) do not indicate whether appellant had been agent for appellee or for the insurance company in the previous transactions. Even if he had been appellee's agent in those transactions, that fact would not have determined his status in the present instance. In the present case he is clearly being treated as agent for the insurance companies which he represents. The complaint alleges his status as "a general insurance agent" (Par. II, first count, R. 2); it alleges that plaintiff applied "to defendant" for insurance (Par. III, first count, R. 2); it refers to "the insurance companies represented by defendant" (Par. VI, first count, R. 3; Par. IV, second count, R. 5); and it alleges that plaintiff "made no attempt to procure fire insurance from any insurance agent other than defendant" (Par. IX, first count, R. 4; Par. VI, second count, R. 5, 6). The arm's length relationship is also disclosed in the correspondence (R. 166 to 175).

²In almost all the cases dealing with this situation, the suit is brought against the insurance company rather than the agent. However, the same test of liability applies to both the insurance company and its agent because where the insurance company is held it is because of the negligence of the agent.

While some of the cases cited by appellee are irrelevant,³ others of them constitute declarations of this rule.

The question immediately arises, how can such liability be asserted in view of immemorial principles of the law of tort? For it is elementary that for tort liability there must be a duty, a breach of that duty, and damages proximately resulting therefrom.

What is the duty in this instance? An application for insurance is an offer to contract. An offeree may accept or reject. He may reject expressly or by inaction. Therefore the cases which hold the insurance companies liable for inaction concede that there is no contract and fix the liability only in tort. But in that case how does the duty arise? It is not created by law, because there is no statute to that effect. It is not created by contract, because there is no contract. What other ground for it is there?

There is no real answer to that question. And the fact that there is no real answer is the basis for the line of decisions which hold that the asserted right of action does not exist. Representative of this line of cases are the following:

Munger v. Equitable Life Assur. Soc. (1933),
2 Fed. Supp. 914;

Schliep v. Commercial Casualty Ins. Co.
(1934), 191 Minn. 479, 254 N.W. 618;

³These were cases where there was a contract to insure, or where the party who was held liable was the agent of the applicant for insurance, not of the insurance company.

- Tjepkes v. State Farmers' Mutual Ins. Co.*
(1935), 193 Minn. 505, 259 N.W. 2;
Zayc v. John Hancock Mutual Life Ins. Co.
(1940), 338 Pa. 426, 13 Atl. (2d) 34;
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National Union Fire Ins. Co. v. School District
(1916), 122 Ark. 179, 182 S.W. 547;
Miller v. Hanson (1943), 69 S. D. 218, 8 N.W.
(2d) 927.

Reference to a few of these decisions will indicate their reasoning.

Munger v. Equitable Life Assur. Soc., supra, contains a thorough critique by District Judge Otis of the doctrine that such an action lies. Judge Otis considers all the grounds for tort liability which are asserted in the various decisions and demonstrates their inadequacy. These grounds, and Judge Otis's responses, are:

1. The equitable principle which considers done what ought to have been done.

This assumes, says Judge Otis, what must be proved, namely, that the application should have been acted upon. If it supports anything, it supports an

action in equity, not at law; and if a law action, one in contract, not tort.

2. The insurance company has a state franchise.

Every corporation has a franchise, but that does not alter elementary law of contract by requiring a corporation to act on offers more promptly than an individual.

3. Good faith makes the insurance company or agent a trustee to return the premium if the application is not accepted.⁴

If this is so, the full duty is to return the premium. The assumption that the trustee has agreed to act one way or the other on the application begs the question whether there is such a duty. Moreover, the enforcement of a trust, with incidental damages, is for equity, not law.

4. The claimed duty arises from the obligation of good faith and fairness and from the public interest involved in the insurance business.

If there is any obligation, it is moral. Neither by statute nor common law is it a legal obligation. In the absence of a statute, the courts must not convert it into a legal one.

The public interest is relevant only to police power, and police power is exercised by the legislature, never by the courts.

⁴No premium was paid or tendered in the case at bar; but the decisions here discussed hold that there is no liability even where premium has been paid.

For brevity, we have greatly compressed Judge Otis's opinion. We respectfully refer this Honorable Court to the opinion as a thorough study of the question.

In *Savage v. Prudential Life Ins. Co., supra*, the court said (121 So. 489) it was "unable to perceive how an action may be maintained in tort which so clearly cannot be maintained on any theory in the contract." It said that the factor of public interest was for the legislature and that unless the legislature should act, the court "is without the power or the desire to trench upon legislative authority."

In *Swentusky v. Prudential Life Ins. Co., supra*, the court (165 Atl. 687, 688) discusses the contention that insurance companies possess franchises and are charged with a public interest, and points out that if because of those facts alone the courts were to impose different tests of liability it would expose the law to chaos. It is not true to say that negligence can only arise where there is a prior legal relationship between the parties. On the contrary, the duty to exercise care arises whenever the activities of two persons come so in conjunction that negligence by one is liable to cause injury to the other, and within this broad principle might conceivably come the applicant for insurance and insurance company agent. But this is subject to limitations. The court continues, "It is a thoroughly established principle of the law of contracts, within the field of which insurance largely lies, that ordinarily a bare offer imposes no liability * * * until it is

accepted * * *” If the offeree neglects it because it is unacceptable or because he has forgotten it, the only result is that there is no contract. This limits the broad doctrine of negligence which might otherwise apply. The court concedes that failure of the insurance company to act may cause loss to applicant, but it says that that is not peculiar to insurance law. For example, “one may make an offer to buy goods * * * at a certain price, having reason to believe the price will advance, and may incur loss through the failure (of) the one to whom it is made to act upon the offer within a reasonable time.”

In *Thorton v. National Council, supra*, the court after stating that the contract of insurance is subject to the general principles of contract and that mere inaction does not create insurance, says (158 S.E. 508), “Yet the theory advanced by appellee, in making the insurer responsible in damages for the amount of the policy because of delay, would accomplish by indirection that which the law will not permit to be done directly.” The court then mentions the argument from public interest, and says, “No reason is apparent why an insurance contract should be regarded as of any more interest to the public than a contract of employment.” “It is of as much importance to the public that a person and his dependents have support during his lifetime (by wages or salary) as that his beneficiaries have a competency (through insurance) after his death. Yet it has never been held that delay in passing upon an application for employment affected the public interest to the extent that it made

the employer liable for all damages arising from such delay.”

In *Schliep v. Commercial Casualty Ins. Co., supra*, the court says (254 N.W. 622) that the reasoning of the foregoing cases appeal to it “as more consonant with reason and established legal principles than those advanced by the courts upholding plaintiff’s theory.” It then says, “it is apparent that if liability is here to be imposed in an action ex delicto this court will be compelled to engage in judicial legislation. If and when it is desired to impose upon insurers additional burdens or requirements, the same should come through the legislative department of the government and not by virtue of judge-made law.”

The late case of *Miller v. Hanson, supra*, considers the two conflicting lines of cases and says (8 N.W. (2d) 927), “The courts which have imposed liability on the theory of tort present strong social or ethical reasons for charging an insurance company with a duty to act promptly on such an application but fail to convince us that the essential legal duty so to do exists. It is elementary that an action ex delicto is founded upon a breach of duty.” The court then concurs in the above quoted language of the *Schliep* case.

Finally, this Honorable Court will find the two lines of cases discussed in *Zayc v. John Hancock Mutual Life Ins. Co., supra*, which was cited in our opening brief. The court in that case (13 Atl. (2d) 36-38) discussed the arguments in favor of a negligence action and found them wanting. Regarding the argument

that an insurance company acts under a state franchise, it said the same is true of other companies similarly related to the public and yet this proposed change in the law of contracts would relate to insurance companies alone. Regarding the social desirability of insurance protection, it said this furnishes "no sufficient legal basis for the imposition upon insurance companies, by a court mindful of the limitations upon its proper functions, of duties or liabilities having no sanction in the established principles of law or in the statutes governing the business."

The foregoing is a swift summary of the decisions which in our judgment represent the sound rule on this subject. Our opinion in this respect is shared by the noted authority on the law of torts, William L. Prosser, now Dean of the University of California School of Jurisprudence. In a thorough article on this subject, which appeared in 3 *University of Chicago Law Review* 39 under the title "Delay in Acting on an Application for Insurance", Mr. Prosser cited the authorities on both sides of this question. Like Judge Otis, the author of the article then separately analyzed every ground which the courts have asserted as a basis for liability in this situation and found them wanting.⁵

⁵In his article in the *Chicago Law Review*, Dean Prosser says, after reviewing the various authorities on the subject, "The infinite variety of these legal theories, not yet withered by age or made stale by custom, suggests that there is no real logical basis for liability, and that the recent cases which have denied it are those which ultimately will be followed. If there is 'a great need for the courts to recognize the position of guardian-

We submit, therefore, that the doctrine embodied in the line of authorities that we have cited is the sound rule in this matter. Applied to the case at bar, this rule calls for a judgment in favor of defendant, as a matter of law. For here, even if plaintiff's letter of April 17th be liberally construed as an "application" for insurance, it remained unaccepted, and by virtue of the doctrine just described there was no basis for liability and no question for the jury. In other words, the issues presented to the jury by the trial court's instructions numbered 3 and 4 (R. 44, 45) were fictitious ones, and instead of giving such instructions the court should have dismissed the case or directed a verdict for defendant.

However, even if this Honorable Court should adopt the opposite doctrine which imposes liability for failure to act on an insurance application, appellant contends that he would nevertheless be entitled to judgment, for any one of three reasons, which we will now state.

ship occupied by the insurer in society and to endow the insurer with a responsibility for efficient action greater than is required of the corner grocer', it should at least be done outright by judicial fiat, instead of warping established concepts to produce a 'novel, interesting and rather surprising' result. It would perhaps be better still to leave such legislation where it properly belongs, and to solve the problem by the passage of statutes similar in character to that of North Dakota." 3 *University of Chicago Law Review*, pp. 58, 59.

II.

EVEN IF AN ACTION WERE TO LIE FOR DELAY IN RESPONDING TO AN APPLICATION, THERE IS NO LIABILITY ON DEFENDANT IN THE PRESENT CASE.

A. No premium paid.

In practically all the cases in which the insurance companies were held liable, the applicant had paid the first premium or had arranged for its payment. This is often stressed. Courts have said that failure to return a premium promptly creates an implied agreement to insure or renders it unfair to deny insurance. It appears extremely doubtful that the line of decisions would have arisen if it had not been for the payment of the premium in those cases. We think it therefore predictable that ultimately even the courts which uphold this type of action will graft upon the doctrine the distinction that the doctrine applies only in cases where the premium has been paid or arranged for. In our case there was no payment or provision for the premium. There was a mere presentation of information.

Appellee has made no response to this point in his brief.

B. No contract existed.

Plaintiff based his case on contract, in both counts. In his second count he sues for breach of the contract (R. 4 to 6). In the first count, he sues for negligent failure to carry out the contract. Thus even the tort count is *based* upon contract. The allegation is contained in paragraph III of the first count, which reads:

“That on the 30th day of March, 1948, plaintiff applied to defendant by letter for insurance against loss or damage by fire upon the above-described property, and defendant, on the 9th day of April, 1948, acknowledged that application by letter and requested a description of the said property, *promising plaintiff upon receipt thereof, to supply the insurance desired by plaintiff.*” (Emphasis supplied) (R. 2, 3).

But the trial court found that no contract existed (R. 31). Thus there was a failure of proof of the basis of the action.

In his brief, appellee does not respond to the point of lack of contract. True, he cites some authorities which uphold an action for negligence. But as seen above, those authorities do not base the negligence on non-performance of a contract; they base it on the relationship between the parties and various factors other than contract. Appellee based the alleged tort upon a contract, and since there was no contract there is no basis for a judgment in his favor.⁶

C. The June 4th letter.

The fire occurred July 20th. On June 4th appellant wrote appellee showing that appellant was not going to write the insurance until the requested information was supplied. As far as appellee's reliance is concerned, it makes no difference that appellant had in its files appellee's letter of April 17th supplying

⁶Appellee says he offered to prove that in a previous discussion appellant had agreed to procure this insurance (Brief for Appellee, p. 14). The answer to that is that the offer was declined by the court (R. 320).

the information or that appellant had been negligent in mislaying the letter. The significant thing is the applicant's state of mind. Therefore even if this Honorable Court should hold that an action lies for delay in responding to an insurance application, appellee's knowledge of appellant's intention in this case is decisive. This can be easily demonstrated.

Suppose that on June 4th, appellant had advised appellee that insurance was refused. Appellee would have had over a month to seek insurance elsewhere. If he had done nothing, the risk would have been his by his own volition, and appellant could not have been liable under any rule that might be adopted. Any antecedent negligence of appellant, if there had been such, would have been completely superseded. It would not be a case of appellant escaping liability on the ground of *contributory negligence* of the appellee; appellee's decision would have been the *sole* cause of his loss. In the respect here involved, appellant's letter of June 4th had the same effect as a refusal of insurance. It showed appellee that appellant was going to do nothing further unless he should hear from appellee. And appellee ignored the letter.

Or another test may be adopted. Suppose that appellant had insured the property promptly after receiving appellee's letter of April 17th. And suppose that on June 4th appellant had sent appellee a written notice of cancellation (these policies contain a standard provision permitting the insurance company to cancel the insurance by giving five days' written notice to the insured). If, as in the present case,

appellee did nothing after getting such a notice, he would have been uninsured by his own choice at the time of the fire. There would have been no possible basis for holding the insurance company or its agent. By failing to do anything after receiving the letter which appellant sent to him on June 4th, appellee placed himself in the same position as omitting to reinsure after getting a notice of cancellation.

Appellee's response to this point is that this contention amounts only to an argument with the verdict of the jury on the question of contributory negligence and the question whether appellant's delay was the proximate cause of appellee's loss (Brief for appellee, p. 16).

But we are arguing this case as a matter of law, not of fact. We say that the case should not have been submitted to the jury unless under a direction to give a verdict for defendant. We say that the deliberate failure of appellee to do anything after receiving the letter of June 4th was the undisputed sole cause of his loss. It was not contributory negligence; it was the sole cause of the damage.

We think that this contention is so clearly decisive that the case may be disposed of upon this point alone, although as we have said, we think the better rule does not permit this type of action in any event.

CONCLUSION.

Appellee devotes considerable space to showing that appellant's office was negligent in failure to insure. We have not argued that point. All our contentions are consistent with an admission of negligence.

As to proof of damage, we have nothing to add to the contentions contained in our opening brief.

For the reasons stated, we respectfully submit that the judgment should be reversed as a matter of law and that judgment for defendant be directed.

Dated, Anchorage, Alaska,
March 26, 1951.

Respectfully submitted,

DAVIS & RENFREW,

By EDWARD V. DAVIS,

BRONSON, BRONSON & MCKINNON,

By HAROLD R. MCKINNON,

Attorneys for Appellant.

No. 12660

United States
Court of Appeals
for the Ninth Circuit.

HARBOR PLYWOOD CORPORATION,
a Corporation,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Transcript of Record

Petition to Review a Decision of the Tax Court
of the United States

NOV 24 1950

PAUL P. O'BRIEN,

Phillips & Van Orden Co., 870 Brannan Street, San Francisco, Calif.

CLERK

No. 12660

United States
Court of Appeals
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HARBOR PLYWOOD CORPORATION,
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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

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APPEARANCES

For Petitioner:

ALFRED J. SCHWEPPE, ESQ.

WARREN A. DOOLITTLE, ESQ.

For Respondent:

WILLIAM E. KOKEN, ESQ.

DOCKET ENTRIES

1948

- Oct. 20—Petition received and filed by taxpayer. Taxpayer notified. Fee paid.
- Oct. 21—Copy of petition served on General Counsel.
- Dec. 8—Answer filed by General Counsel.
- Dec. 8—Request for hearing in Seattle, Wash., filed by General Counsel.
- Dec. 9—Notice issued placing proceeding on Seattle, Wash., calendar. Service of answer and request made.

1949

- Apr. 14—Hearing set June 13, 1949, Seattle, Wash.
- May 20—Notice changing place of hearing to Tacoma, Wash.
- June 14—Hearing had before Judge LeMire on merits. Stipulation of facts. Appearance of Warren A. Doolittle filed. Motion to amend petition and amendment filed and granted. Answer to amendment to petition and amendment to respondent's answer filed. Petitioner's answer filed. Petitioner's brief July 29, 1949; Respondent's brief Aug. 29, 1949; Petitioner's reply Sept. 19, 1949.
- July 28—Brief filed by taxpayer (2). Copy has been served. 1 copy received 8/1/49; served 8/2/49. Copy served.

1949

- Aug. 2—Transcript of hearing 6/14/49 filed.
Aug. 29—Brief filed by General Counsel.
Sept. 19—Reply brief filed by taxpayer, with receipt of service of reply brief on general counsel. Copy served 9/20/49.

1950

- Jan. 31—Findings of fact and opinion rendered—Judge LeMire. Decision will be entered under Rule 50. Copy served 2/1/50.
Apr. 21—Agreed computation filed.
Apr. 25—Decision entered, Judge LeMire, Division No. 5.
July 7—Motion for order fixing amount of bond not to exceed \$62,280.84 filed by taxpayer.
July 12—Bond in the amount of \$100,000.00 approved and ordered, filed.
July 17—Petition for review by U. S. Court of Appeals, 9th Circuit, with assignments of error, filed by taxpayer.
July 19—Proof of service filed.
July 26—Proof of service of petitioner for review filed.
Aug. 7—Praecipe for record, with proof of service thereon, filed by taxpayer.

The Tax Court of the United States

Docket No. 20729

HARBOR PLYWOOD CORPORATION,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION

The above-named petitioner hereby petitions for a re-determination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency, IT:90D:JHQ, (Office of Internal Revenue Agent in Charge, Seattle Division, 305A Jones Building, 1331 Third Avenue, Seattle, Washington) dated July 23, 1948 (Form 1279), and as a basis of its proceeding alleges as follows:

1. The petitioner is a corporation incorporated on May 5, 1929, under the laws of the State of Delaware, with principal office located at Hoquiam, Washington. The return for the periods here involved were filed with the Collector for the District of Washington.

2. The Notice of Deficiency (a copy of which is attached hereto and marked Exhibit "A") was mailed to the petitioner on July 23, 1948.

3. The taxes in controversy are income taxes and excess profits taxes for the calendar years 1943

and 1944, and income taxes for the calendar year 1945, and are in the following amounts:

(a) For the year 1943, over-assessment of income taxes \$32,618.87 and deficiency in excess profits taxes \$95,028.66, or a net deficiency for 1943 of \$62,409.79; for the year 1944, an over-assessment of income taxes of \$2,321.25 and a deficiency of excess profits taxes of \$17,407.58, or a net deficiency for the year 1944 of \$15,086.33; for the year 1945, deficiency of income tax of \$24,219.57, all as more particularly set forth on Exhibit "B" attached hereto.

(b) The taxpayer, after receipt of said Notice of Deficiency and by execution of Form 874 on September 8, 1948, waived and consented to the assessment and collection of the following deficiencies and has accepted the following over-assessments as correct: For the year 1943, over-assessment of income taxes \$26,425.93 and deficiencies of excess profits taxes \$73,098.95, or a net deficiency for the calendar year 1943 of \$46,673.02; for the year 1944, over-assessment of income taxes \$2,411.86 and over-assessment of excess profits tax \$800.12, or a total over-assessment for 1944 of \$3,211.98; for the year 1945, deficiency of income tax of \$17,820.79; that the total net deficiencies to which a consent was given by the taxpayer for the three years 1943, 1944 and 1945 was \$61,281.83; that said \$61,281.83 has been paid by voluntary settlement payments made on December 26, 1945, of \$32,455.94 and further voluntary payment of \$28,825.89 made on September 22,

1948, all as more particularly set forth on Exhibit "C" attached hereto. (That the Bureau of Internal Revenue has advised the petitioner that it can not schedule an over-assessment in an amount greater than that shown in the Notice of Deficiency, nor can it schedule an over-assessment in place of a deficiency in the manner set forth by petitioner on Form 874; that, accordingly, taxpayer will immediately file protective claims for refund for such over-assessments.)

(c) That the resulting deficiencies and over-assessments asserted by the respondent and disputed by the petitioner are: For the year 1943, income tax over-assessment of \$6,192.94 and excess profits tax deficiency of \$21,929.71, or a net deficiency for 1943 of \$15,736.77; for the year 1944, income tax deficiency of \$90.61, excess profits tax deficiency of \$18,207.70, or a net deficiency for 1944 of \$18,298.31; for the year 1945, a deficiency of income tax of \$6,398.78; or a total disputed net deficiency for the three years of \$40,433.86.

4. The determination of the tax set forth in said Notice of Deficiency is based upon the following errors:

(a) The respondent held that the petitioner received taxable income as defined in Section 22 (a), Section 41 and Section 42 (a) of the Internal Revenue Code in the taxable year ended December 31, 1943, in the amount of \$11,591.36, as evidenced by credit memorandum dated March 31, 1943, issued

by Pacific Forest Industries in petitioner's favor, representing petitioner's proportionate share of refund of excessive commissions charged the members by the Association during the Association's fiscal year April 1, 1942, to March 31, 1943, based on plywood supplied by petitioner to the Association and shipped by the Association during the latter's fiscal year. Petitioner reported no income from this source and respondent increased petitioner's income by the above amount.

(b) Respondent held that petitioner received taxable income as defined in Section 22 (a), Section 41 and Section 42 (a) of the Internal Revenue Code in the taxable year ended December 31, 1944, in the amount of \$33,113.41, as evidenced by credit memorandum dated March 31, 1944, issued by Pacific Forest Industries in petitioner's favor, representing petitioner's proportionate share of refund of excessive commissions charged the members by the Association during the Association's fiscal year April 1, 1943, to March 31, 1944, based on plywood supplied by petitioner to the Association and shipped by the Association during the latter's fiscal year. Petitioner reported income from this source in its return in the amount of \$11,591.36 and respondent, therefore, increased net income by the difference of \$21,522.05.

(c) Respondent held that petitioner received taxable income as defined in Section 22 (a), Section 41 and Section 42 (a) of the Internal Revenue Code in the taxable year ended December 31, 1945, in

the amount of \$15,996.95, as evidenced by credit memorandum dated March 31, 1945, issued by Pacific Forest Industries in petitioner's favor, representing petitioner's proportionate share of refund of excessive commissions charged the members by the Association during the Association's fiscal year April 1, 1944, to March 31, 1945, based on plywood supplied by the petitioner to the Association and shipped by the Association during the latter's fiscal year. Petitioner reported no income from this source and the respondent held net income to be increased by the above amount;

when, in fact, in each of the tax years in question the petitioner had not received taxable income as defined in Section 22 (a), Section 41 and Section 42 (a) of the Internal Revenue Code in the amount of said credit memoranda, and, therefore, such refunds should not have been accrued.

5. The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(a) Pacific Forest Industries is a cooperative association, organized under the laws of the State of Washington, and licensed to do business under the Export Trade Act; that this Association at all times material herein was engaged in the exporting of plywood for its members and operated on a fiscal year accounting period ending March 31st of each year; that after the end of its fiscal year, its funds in excess of annual expenses are computed and returned to its members, if and when funds are available, on the basis of footages of plywood delivered

by each member to the Association during the preceding fiscal year.

(b) That the petitioner, Harbor Plywood Corporation, is an accrual basis taxpayer reporting on a calendar year basis.

(c) That the petitioner, Harbor Plywood Corporation, is a member of Pacific Forest Industries.

(d) That Pacific Forest Industries' refund to petitioner for Pacific Forest Industries' fiscal year ended March 31, 1944, was not made until January 29, 1946, and that the refund for the fiscal year ending March 31, 1945, was not made until July 23, 1946, for the reason that it had been held by the Treasury Department, Procurement Division, which purchased all of Pacific Forest Industries' sales during the war years here in question; that Pacific Forest Industries' income was subject to renegotiation under the Renegotiation Act, as amended, notwithstanding vigorous efforts made by Pacific Forest Industries to be exempted from renegotiation; that the refund to petitioner for Pacific Forest Industries' fiscal year ending March 31, 1943, in the amount of \$11,591.36, was made on December 12, 1944, and reported by petitioner for its year ending December 31, 1944, for the reason that Pacific Forest Industries' income for the fiscal year ended March 31, 1943, would not be renegotiated.

(e) That because Pacific Forest Industries was held subject to renegotiation, it did not pay any

refunds whatsoever to the member mills for its fiscal years ending March 31, 1944, and March 31, 1945, until either renegotiation proceedings were completed or until the statutory period had run against renegotiation; that until such time had elapsed, it was legally uncertain what, if any, refund could be made by Pacific Forest Industries to the member mills; that during that period, petitioner had no enforceable claim against Pacific Forest Industries because any such refund was contingent, remote, indefinite and wholly indeterminate as to amount and had not been credited to or set apart for the taxpayer without restriction.

(f) That, because of the possibility of renegotiation, such credit memoranda were not set apart to the petitioner without any substantial limitation or restriction as to the time of payment or condition upon which payment was to be made and were not made available to the petitioner so that petitioner might draw such credit amounts at any time after the date of such memoranda and the receipt thereof was not brought within the petitioner's own control and disposition.

(g) That the petitioner did not constructively receive such refunds at the time and in the year when such memoranda were issued; that petitioner consistently reported as income the refunds from Pacific Forest Industries only at the time the cash was received for the aforementioned reasons and on the grounds that the taxpayer had no claim on, or unconditional right to, receive a determinate amount of these funds until the time of actual cash receipt.

Wherefore, petitioner prays that this court may hear the proceeding and find that the respondent's proposed adjustment of income in respect of refunds from Pacific Forest Industries for the Petitioner's calendar years 1943, 1944 and 1945 should not be made and that the proposed deficiencies for those years resulting from the respondent's adjustments should be corrected to reflect this change, and that the petitioner's computation of adjusted over-assessments and deficiencies for the years 1943, 1944 and 1945 as set forth on Exhibit "C" be approved.

/s/ ALFRED J. SCHWEPPE,
Counsel for Petitioner, Har-
bor Plywood Corporation.

State of Washington,
County of Grays Harbor—ss.

G. O. Baker, Jr., being duly sworn, says that he is the Comptroller of Harbor Plywood Corporation, the petitioner above named; that he is an officer of said corporation and is duly authorized to verify the foregoing petition; that he has read the foregoing petition and is familiar with the statements contained therein, and that the statements contained therein are true, except those stated to be upon information and belief, and that those he believes to be true.

/s/ G. O. BAKER, JR.

Subscribed and sworn to before me this 16th day of October, 1948.

[Seal] /s/ L. A. ST. ROMAIN,
Notary Public in and for the State of Washington,
residing at Hoquiam, Washington.

Exhibit "A"

Form 1279 (Rev. Mar. 1946)

SN-IT-7

[Seal]

Office of Internal Revenue Agent in Charge
Seattle Division,
305 A Jones Building
1331 Third Avenue

IT: 90D: JEQ

Treasury Department
Internal Revenue Service
Seattle 1, Washington

July 23, 1948

Harbor Plywood Corporation
Box 300
Hoquiam, Washington

Gentlemen:

You are advised that the determination of your income tax liability for the taxable year ended December 31, 1945, discloses a deficiency of \$24,219.57, and that the determination of your excess profits tax liability for the taxable years ended December 31, 1944, and December 31, 1945, discloses a deficiency of \$112,436.24, and that the determination of your income tax liability for the taxable years ended December 31, 1943, and December 31, 1944, discloses an over-assessment of \$34,940.12, as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency or deficiencies mentioned.

Within 90 days (not counting Saturday, Sunday, or legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with the Tax Court of the United States, at its principal address, Washington 25, D. C., for a redetermination of the deficiency or deficiencies.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Internal Revenue Agent in Charge, Seattle 1, Washington, for the attention of IT:90D:JEQ. The signing and filing of this form will expedite the closing of your return(s) by permitting an early assessment of the deficiency or deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Very truly yours,

GEO. J. SCHOENEMAN,
Commissioner.

By /s/ S. R. STOCKTON,
Internal Revenue Agent in
Charge.

JEQ:mts

Enclosures:

Statement

Form of Waiver and Acceptance.

EXHIBIT "B"

Harbor Plywood Corporation

Box 300

Hoquiam, Washington

Tax Liability for the Taxable Years Ended December 31, 1943,
December 31, 1944, and December 31, 1945

Year	Liability	Assessed Income Tax	Deficiency	Over- assessment
1943.....	\$129,776.21	\$162,395.08		\$32,618.87
1944.....	118,369.30	120,690.55		2,321.25
1945.....	90,078.97	65,859.40	\$ 24,219.57	
Total.....	\$338,224.48	\$348,945.03	\$ 24,219.57	\$34,940.12
Excess Profits Tax				
1943.....	\$225,388.25	\$130,359.59	\$ 95,028.66	
1944.....	136,200.54	118,792.96	17,407.58	
Total.....	\$361,588.79	\$249,152.55	\$112,436.24	

EXHIBIT "C"

Harbor Plywood Corporation

Computation of Net Deficiencies (Over-Assessments) for the Calendar Years 1943, 1944 and 1945, Based on Revenue Agent's Adjustments Other Than Pacific Forest Industries Refund Adjustments

	Adjusted Tax Liabilities	Taxes Previously Assessed (per returns)	Total Deficiencies (over-assessments)	Voluntary Settlement 12-26-45		Net Deficiencies (over-assessments)
				Deficiencies (over-assessments)		
Year 1943—						
Income taxes	\$135,969.16	\$162,395.09	\$ (26,425.93)	\$ (696.73)		\$ (25,729.20)
Excess profits taxes....	203,458.54	130,359.59	73,098.95	16,881.14		56,217.81
Year 1944—						
Income taxes	118,278.69	120,690.55	(2,411.86)	(817.22)		(1,594.64)
Excess profits taxes....	117,992.84	118,792.96	(800.12)	17,088.75		(17,888.87)
Year 1945—						
Income tax	83,680.19	65,859.40	17,820.79	-----		17,820.79
			<u>\$ 61,281.83</u>	<u>\$32,455.94</u>		<u>\$ 28,825.89*</u>

* Paid 9/22/48.

Received and filed T.C.U.S. October 20, 1948.

Served October 21, 1948.

[Title of Tax Court and Cause.]

ANSWER

Now comes the Commissioner of Internal Revenue, by his attorney, Charles Oliphant, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition filed herein admits and denies as follows:

1. Admits the allegations contained in paragraph 1 of the petition.

2. Admits that the notice of deficiency in controversy in the present proceeding was mailed to petitioner on July 23, 1948. Denies that Exhibit "A" attached to the petition represents a complete copy of said notice of deficiency.

3. Admits that the taxes in controversy are excess profits taxes for the calendar years 1943 and 1944, and income taxes for the calendar year 1945. Denies that over-assessments in income taxes or other taxes than those specified are in controversy before the Tax Court in this proceeding.

(a) Admits that for the years 1943 and 1944 the deficiency notice determined deficiencies and over-assessments in the amounts set forth in paragraph 3 (a) and shown in Exhibit "B" attached to the petition. Denies that the petitioner has placed in controversy in this proceeding the entire

deficiencies which have been determined as set forth therein. Denies the remaining allegations contained in subparagraph (a) of paragraph 3 of the petition.

(b) and (c). For lack of information from which to determine the truth or correctness of the allegations contained in subparagraphs (b) and (c) of paragraph 3 of the petition, the same are denied.

4. (a), (b) and (c). Denies that in determining the deficiencies as set forth in the statutory notice the respondent committed any errors, and specifically denies that the respondent erred as alleged in subparagraphs (a), (b) and (c) and the remaining provisions of paragraph 4 of the petition.

5. (a). Denies the allegations contained in subparagraph (a) of paragraph 5 of the petition.

(b) and (c). Admits the allegations contained in subparagraphs (b) and (c) of paragraph 5 of the petition.

(d), (e), (f), and (g). Denies the allegations contained in subparagraphs (d), (e), (f) and (g) of paragraph 5 of the petition.

6. Denies generally and specifically each and every material allegation contained in the petition, not hereinbefore specifically admitted, qualified or denied.

Wherefore, it is prayed that the petitioner's appeal be denied and that the Commissioner's deter-

mination be approved.

/s/ CHARLES OLIPHANT, DLB

Chief Counsel, Bureau of

Internal Revenue.

Of Counsel:

WILFORD H. PAYNE,

Division Counsel,

DOUGLAS L. BARNES,

Special Attorney,

Bureau of Internal Revenue.

Received and filed T. C. U. S. December 8, 1948.

[Title of Tax Court and Cause.]

MOTION TO AMEND PETITION

Comes now the petitioner and moves this Court for an order authorizing the petitioner to amend its petition herein in the form and manner set forth on the copy of the proposed Amended Petition attached hereto.

This Amended Petition is necessary (1) to set forth more fully the material portions of the statement attached to the Notice of Deficiency to which the petitioner's assignments of error are directed, as required by Rule 7(c)(4)(I); and (2) to set forth the petitioner's alternative contention as to the proper time for including the disputed items in the petitioner's taxable income, as now alleged

in paragraph 5(h) of the attached Amended Petition.

/s/ ALFRED J. SCHWEPPE,
Counsel for Petitioner, Harbor Plywood Corporation.

No objection:

/s/ CHARLES OLIPHANT, D.L.B.
Counsel for Respondent.

Granted June 13, 1949. C. P. LeMire, Judge.

Filed T.C.U.S. June 13, 1949.

[Title of Tax Court and Cause.]

AMENDMENT TO PETITION

Comes now the petitioner and, pursuant to leave of the Court obtained herein, amends its Petition heretofore filed herein in the following particulars:

1. Paragraph 2 of the Petition shall be amended by adding the following:

The material portions of the statement attached to the Notice of Deficiency to which the petitioner's assignments of error are directed are as follows:

(a) As to the petitioner's taxable year ended December 31, 1943:

“(f) It is held that you received taxable income as defined in Section 22(a), Section 41 and Section 42(a) of the Internal Revenue Code, in this year in the amount of \$11,591,36,

as evidenced by credit memorandum dated March 31, 1943, issued by Pacific Forest Industries in your favor, representing your proportionate share of refund of excessive commissions charged the members by the association during the association's fiscal year April 1, 1942, to March 31, 1943, based on plywood supplied by you to the association and shipped by them during this period. You reported no income from this source; therefore net income is increased by the above amount."

(b) As to the petitioner's taxable year ended December 31, 1944:

"(f) It is held that you received taxable income as defined in Section 22(a), Section 41 and Section 42(a) of the Internal Revenue Code, in this year in the amount of \$33,113.41, as evidenced by credit memorandum dated March 31, 1944, issued by Pacific Forest Industries in your favor, representing your proportionate share of refund of excessive commissions charged the members by the association during the association's fiscal year April 1, 1943, to March 31, 1944, based on plywood supplied by you to the association, and shipped by them during this period. You reported income from this source in the return in the amount of \$11,591.36; therefore, net income is increased by the difference of \$21,522.05."

(c) As to petitioner's taxable year ended December 31, 1945:

“(f) It is held that you received taxable income as defined in Section 22(a), Section 41 and Section 42(a) of the Internal Revenue Code, in this year in the amount of \$15,996.95, as evidenced by credit memorandum dated March 31, 1945, issued by Pacific Forest Industries in your favor, representing your proportionate share of refund of excessive commissions charged the members by the association during the association's fiscal year April 1, 1944, to March 31, 1945, based on plywood supplied by you to the association, and shipped by them during this period. You reported no income from this source; therefore net income is increased by the above amount.”

2. Paragraph 5 of the Petition shall be amended by adding the following sub-paragraph (h) thereto:

(h) That, in the alternative, each credit memorandum issued by Pacific Forest Industries to the petitioner, Harbor Plywood Corporation, was not includable in any event in the petitioner's taxable income for any period prior to the year during which the statute of limitations expired on the renegotiability of Pacific Forest Industries.

Wherefore petitioner renews the prayer of his original Petition herein and adds thereto the prayer that, in the alternative, the amount of each credit memorandum be not included in any event in the

petitioner's taxable income for any period prior to the year during which the statute of limitations expired on the renegotiability of Pacific Forest Industries.

/s/ ALFRED J. SCHWEPPE,
Counsel for Petitioner, Harbor Plywood Corporation.

State of Washington,
County of Grays Harbor—ss.

G. O. Baker, Jr., being duly sworn, says that he is the Comptroller of Harbor Plywood Corporation, the petitioner above named; that he is an officer of said corporation and is duly authorized to verify the foregoing Amended Petition; that he has read the foregoing Amended Petition and is familiar with the statements contained therein, and that the statements contained therein are true, except those stated to be upon information and belief, and that those he believes to be true.

/s/ G. O. BAKER, JR.

Subscribed and Sworn to before me this 27th day of May, 1949.

[Seal] /s/ L. A. ST. ROMAIN,
Notary Public in and for the
State of Washington.

Filed T.C.U.S. June 13, 1949.

[Title of Tax Court and Cause.]

ANSWER TO AMENDMENTS TO PETITION
AND AMENDMENT TO RESPONDENT'S
ANSWER

Now comes the Commissioner of Internal Revenue, by his attorney, Charles Oliphant, Chief Counsel, Bureau of Internal Revenue, and in answer to the amended petition filed at the hearing herein, and for further answer, admits, alleges and denies as follows:

1. Paragraph 2 of the answer is amended by adding the following at the end thereof: "(a), (b), and (c). Admits the allegations contained in subparagraphs (a), (b) and (c) of paragraph 2 of the petition, as added by petitioner's amendments to petition."

2. Paragraph 5 of the answer is amended by adding the following at the end thereof: "(h). Admits that petitioner's alternative contention is that each credit memorandum issued by Pacific Forest Industries to the petitioner, Harbor Plywood Corporation, was not includible in any event in the petitioner's taxable income for any period prior to the year during which the statute of limitations expired on the renegotiability of Pacific Forest Industries, as alleged in subparagraph (h) of paragraph 5 of the petition, as added by petitioner's amendments to the petition."

3. The respondent's answer is hereby further

amended by adding to paragraphs 1 to 6, inclusive, thereof the following additional paragraph: "7. For further answer to the petition as amended by petitioner's amendments to petition, the respondent alleges that in the event the Court shall determine that the aforesaid credit memorandums constitute accrued income of the petitioner for the year during which the statute of limitations expired on the renegotiability of the Pacific Forest Industries, instead of income for the years in which the said credit memorandums were issued, then there is a deficiency in petitioner's excess profits tax for 1943 in the amount of \$99,915.35, instead of \$95,028.66 as set forth in the deficiency notice, or an additional deficiency in the said tax in the amount of \$4,886.69, and a deficiency in petitioner's income tax for 1945 in the amount of \$31,066.15, instead of \$24,219.57 as set forth in the deficiency notice, or an additional deficiency in the said tax in the amount of \$6,846.58."

Wherefore, respondent respectfully prays that the petition as amended be denied and, if the Court shall determine that the aforesaid credit memorandums constitute accrued income of the petitioner for the year during which the statute of limitations expired on the renegotiability of Pacific Forest Industries, instead of income for the years in which the said credit memorandums were issued, that the Court determine also that there are increased deficiencies in petitioner's excess profits tax and income tax for 1943 and 1945, respectively, in the

amounts set forth above, claim for which is hereby made pursuant to the provisions of Section 272(e) of the Internal Revenue Code.

/s/ CHARLES OLIPHANT, DLB

Chief Counsel, Bureau of
Internal Revenue.

Of Counsel:

WILFORD H. PAYNE,
Division Counsel.

DOUGLAS L. BARNES,
W. E. KOKEN,
Special Attorneys,
Bureau of Internal Revenue.

Filed T.C.U.S. June 14, 1949.

[Title of Tax Court and Cause.]

STIPULATION OF FACTS

It is hereby stipulated and agreed by and between the parties hereto, by their respective counsel, that the following facts are true and may be taken and considered by the Court as offered in evidence by the parties to this proceeding.

1. The petitioner is a corporation organized on May 5, 1929, under the laws of the State of Delaware with principal office located at Hoquiam, Washington, and it is engaged in the business of manufacturing and distributing plywood, doors and building materials. It is an accrual basis taxpayer reporting on a calendar year basis, and the returns

for the periods here involved were filed with the Collector for the District of Washington.

2. The notice of deficiency was mailed to the petitioner on July 23, 1948. The taxes in controversy are excess profits taxes for the calendar years 1943 and 1944 in the amounts of \$95,028.66 and \$17,407.58, respectively, and income taxes for the calendar year 1945 in the amount of \$24,219.57, as shown in the statement accompanying the respondent's notice of deficiency.

3. Pacific Forest Industries is a cooperative association organized under the laws of the State of Washington for the purpose of engaging solely in the export of plywood and other forest products, as authorized by the provisions of the Webb Export Trade Act, for its members. The association operates on a fiscal year accounting period ending March 31, and is a corporation under the laws of the State of Washington.

4. The petitioner, Harbor Plywood Corporation, at all times material herein was a stockholder member of Pacific Forest Industries.

5. Under date of March 31, 1943, Pacific Forest Industries issued a credit memorandum to Harbor Plywood Corporation in the amount of \$11,591.36. The said amount, which is stated on the face of the credit memorandum, represented the petitioner's proportionate share of the refund of excessive commissions charged the members of the association during its fiscal year ending March 31, 1943. The

said \$11,591.36 was not reported as income by the petitioner for its tax year ending December 31, 1943, but was reported as income by the petitioner in its tax year ending December 31, 1944, the same having been paid to petitioner by Pacific Forest Industries on December 12, 1944. A copy of said credit memorandum is attached hereto and marked as "Joint Exhibit 1-A."

6. Under date of March 31, 1944, Pacific Forest Industries issued a credit memorandum to Harbor Plywood Corporation in the amount of \$33,113.41. The said amount, which is stated on the face of the credit memorandum, represented the petitioner's proportionate share of the refund of excessive commissions charged the members of the said association during its fiscal year ending March 31, 1944. The said \$33,113.41 was not reported as income by the petitioner for its tax year ending December 31, 1944, but was reported as income by the petitioner in its tax year ending December 31, 1946, the same having been paid to petitioner by Pacific Forest Industries on January 29, 1946. A copy of said credit memorandum is attached hereto and marked as "Joint Exhibit 2-B."

7. Under date of March 31, 1945, Pacific Forest Industries issued a credit memorandum to Harbor Plywood Corporation in the amount of \$15,996.95. The said amount, which is stated on the face of the credit memorandum, represented the petitioner's proportionate share of the refund of excessive commissions charged the members of the association

during its fiscal year ending March 31, 1945. The said \$15,996.95 was not reported as income by the petitioner for its tax year ending December 31, 1945, but was reported as income by the petitioner in its tax year ending December 31, 1946, the same having been paid to petitioner by Pacific Forest Industries on July 23, 1946. A copy of said credit memorandum is attached hereto and marked as "Joint Exhibit 3-C."

8. The issuance and the amounts of the said credit memorandums were governed by the Articles of Incorporation and By-Laws of the Pacific Forest Industries, a copy of which as they existed at all times material herein are attached hereto as "Joint Exhibit 4-D."

9. Subject to the right of the petitioner, which is hereby noted and reserved, to object to its relevancy, it is further stipulated that the face amount of each of the said credit memorandums was credited on the books of the Pacific Forest Industries to the petitioner Harbor Plywood Corporation as of the date of issuance, and was also claimed by the Pacific Forest Industries and allowed by the respondent as an exclusion from gross income in the income tax returns of Pacific Forest Industries.

10. The question before the Court is: Does the face amount of each credit memorandum constitute a part of the taxable income of the petitioner Harbor Plywood Corporation (1) for the year in which issued by Pacific Forest Industries, as held by the

respondent; or (2) for the year during which the statute of limitations expired on the renegotiability of Pacific Forest Industries, or (3) for the year in which they were paid to petitioner in cash by Pacific Forest Industries? The petitioner contends that the amount of each credit memorandum is includible in the petitioner's income for the year in which they were paid to petitioner in cash by Pacific Forest Industries, or, in the alternative, that it is not includible in any event in the petitioner's taxable income for any period prior to the year during which the statute of limitations expired on the renegotiability of Pacific Forest Industries. The respondent contends that the amount of each credit memorandum is includible in the petitioner's taxable income for the year in which issued, or, in the alternative, that it is includible in any event in the petitioner's taxable income for the year during which the statute of limitations expired on the renegotiability of Pacific Forest Industries. For Pacific Forest Industries' fiscal year ending March 31, 1943, the said period of limitations expired on or about March 31, 1944; for its fiscal year ending March 31, 1944, the said period expired on or about May 11, 1945; and for its fiscal year ending March 31, 1945, the said period expired on or about May 29, 1946, so that if the Court should determine that the aforesaid credit memorandums constitute taxable income of the petitioner Harbor Plywood Corporation for the year during which the statute of limitations expired on the renegotiability of Pacific Forest Industries, the aforesaid credit memoran-

dums will constitute taxable income of the petitioner Harbor Plywood Corporation in the amounts and for the years as follows:

Date of Credit Memorandum	Amount	Year Accruable in Petitioner's Income
March 31, 1943.....	\$11,591.36	1944
March 31, 1944.....	33,113.41	1945
March 31, 1945.....	15,996.95	1946

11. In the event that the Court should hold that the aforesaid credit memorandums constitute accrued income of the petitioner in the amounts and for the years as set forth in paragraph 10 above, as contended by both parties in the alternative, instead of income for the years in which the said credit memorandums were issued as held by the respondent, then there is a deficiency in petitioner's excess profits tax for 1943 in the amount of \$99,915.35 instead of \$95,028.66 as set forth in the deficiency notice, or an additional deficiency in the said tax in the amount of \$4,886.69, and a deficiency in petitioner's income tax for 1945 in the amount of \$31,066.15 instead of \$24,219.57 as set forth in the deficiency notice, or an additional deficiency in the said tax in the amount of \$6,846.58; and it is hereby further stipulated and agreed that claim for the said increased deficiencies has been asserted by the respondent in accordance with the provisions of Section 272(e), Internal Revenue Code.

12. Subject to the right of the respondent, which is hereby noted and reserved, to object to their relevancy, the following additional documents are attached hereto as joint exhibits and included as a part of this stipulation:

Joint Exhibit 5-E

Letter dated January 15, 1943, from War Department Price Adjustment Board addressed to Pacific Forest Industries, and two enclosures, respecting renegotiation proceedings.

Joint Exhibit 6-F

Letter dated April 24, 1943, from Pacific Forest Industries addressed to nineteen of its members enclosing credit memorandum.

Joint Exhibit 7-G

Letter dated June 4, 1943, from Procurement Division, Treasury Department, addressed to Pacific Forest Industries, and one enclosure, respecting renegotiation proceedings.

Joint Exhibit 8-H

Letter dated June 15, 1943, from Procurement Division, Treasury Department addressed to Pacific Forest Industries.

Joint Exhibit 9-I

Letter dated March 30, 1944, from Mr. Alfred J. Schweppe addressed to Henry Relf of Pacific Forest Industries and one enclosure respecting the renegotiation of Pacific Forest Industries.

Joint Exhibit 10-J

Memorandum dated May 4, 1944, from Pacific Forest Industries to its stockholders enclosing balance sheet and statement of operations for fiscal year ending March 31, 1944.

Joint Exhibit 11-K

Letter dated June 21, 1944, from Procurement Division, Treasury Department, addressed to Pacific Forest Industries respecting renegotiation.

Joint Exhibit 12-L

Letter dated June 26, 1944, from Pacific Forest Industries addressed to Alfred J. Schweppe respecting Pacific Forest Industries' fiscal year ending March 31, 1944.

Joint Exhibit 13-M

Letter dated June 27, 1944, from Alfred J. Schweppe addressed to Henry Relf respecting renegotiation.

Joint Exhibit 14-N

Letter dated June 27, 1944, from Alfred J. Schweppe addressed to Henry Relf respecting renegotiation.

Joint Exhibit 15-O

Letter dated May 4, 1949, from Pacific Forest Industries to Messrs. McMicken, Rupp & Schweppe concerning Joint Exhibit 13-M.

/s/ ALFRED J. SCHWEPPE,
Counsel for Petitioner.

/s/ CHARLES OLIPHANT, WHP
Chief Counsel, Bureau of Internal Revenue, Counsel
for Respondent.

JOINT EXHIBIT 1-A

Pacific Forest Industries
Exporters of Plywood

Tacoma, Wash., U. S. A.
March 31, 1943.

Shipped to	Sold to Harbor Plywood Corp.
Vessel	Address Hoquiam, Washington
Your Order No.	Our Order No.

Credit Memorandum

To additional price of \$2.531296 per
thousand square feet on 4,579,221 square
feet $\frac{3}{8}$ " rough basis, supplied by you and
shipped by us during the period April 1,
1942, through March 31, 1943.....\$11,591.36

Cr. Misc. Income

[Illegible date.]

E. & O. E.

PACIFIC FOREST
INDUSTRIES,

By

JOINT EXHIBIT 2-B

Pacific Forst Industries
Exporters of Plywood

Tacoma 2, Wash., U. S. A.
March 31, 1944.

Shipped to	Sold to Harbor Plywood Corp.
------------	------------------------------

M. Sekstrom of Olympia Veneer Company

V. A. Nyman of Aberdeen Plywood Company
each a citizen of the State of Washington, and

Neil Malarkey of Plylock Corporation

James A. Malarkey of M and M Plywood Corporation

Arthur J. Gram of Vancouver Plywood & Veneer Co.

each a citizen of the State of Oregon, hereby associate themselves together as a co-operative association pursuant to the provisions of Chapter 19 of Laws of Washington, 1913, and of Chapter 99 of Laws of Washington, Extraordinary Session, 1925, and do hereby make, subscribe and acknowledge, in triplicate, the following articles of association:

Article I.

The name of this association shall be Pacific Forest Industries.

Article II.

The sole purpose for which this association is organized is to engage in the export trade in plywood and other forest products and the promotion and development of such trade, and to that end to do any and all things lawful and proper to be done therein, as authorized by the provisions of the 'Webb Export Trade Act.'

Article III.

The principal place of business of the association shall be Tacoma, Pierce County, Washington.

Article IV.

The term of the existence of this association shall be three years.

Article V.

The amount of the capital stock of the association shall be 250 shares, each share of the par value of \$100.00, making a total capitalization of \$25,000.00. Said stock shall be subscribed only by concerns engaged in the manufacture of plywood or by their duly authorized representative, and said stock shall not be assignable, except to the association, without the unanimous consent of all stockholders.

Article VI.

The association shall be managed by a board of thirteen trustees who shall be elected for a term of one year. The trustees for the period until the first election shall be:

E. E. Westman

Craig L. Spencer

Neil Malarkey

W. C. Bailey

James A. Malarkey

Arthur J. Gram

A. R. Wuest

Philip Garland

E. W. Daniels

M. Sekstrom

N. O. Cruver

V. A. Nyman

J. R. Robinson

In Witness Whereof, we have signed these Ar-

Article I.

Membership

1. There shall be two classes of membership of this Association:

(a) Shareholder member, hereinafter called the "member," and

(b) Non-shareholder member, hereinafter called "associate member."

2. Each concern (to wit, operating plant) engaged in the manufacture of Western softwood plywood in either of the States of Washington or Oregon may become either a member or an associate member of this Association upon the two-thirds vote of the Executive Committee.

3. To become a member, such concern shall subscribe and pay for, at par, 5 shares of the capital stock of this Association for each 1,000,000 feet capacity, or fraction thereof, of plywood on a $\frac{3}{8}$ inch rough basis monthly, of such concern, and shall have all rights of membership as set forth in these by-laws; provided that the Board of Trustees or the Executive Committee may change the foregoing formula, from time to time in its discretion, by reducing or increasing the number of shares per 1,000,000 feet as aforesaid to be held by a member, so as to keep the total membership within the authorized capital stock of the association, and so as to have the fullest possible amount of the authorized capital stock standing; and that the Board of Trustees or

the Executive Committee may authorize the call and redemption, or issue, of any stock required to be called and redeemed, or issued, by reason of such change in the foregoing formula. Any change in the foregoing formula shall be incorporated in an appropriate resolution incorporated in the minutes of the association and notation thereof made on the margin of this by-law.

4. Each member, regardless of the number of shares of stock owned, shall be entitled to only one vote at stockholders' meetings. Each member shall make formal appointment of its representative to vote its stock at all stockholders' meetings, provided that an alternative appointment, in writing, may be made by the member at any time.

5. Such concern not a member of this association may become an associate member upon application approved by the Executive Committee.

6. Associate members shall have no vote in the affairs of the Association nor representation on its Board of Directors, and shall not be entitled to be included in the allocation schedule hereinafter provided for, and shall only be entitled to receive such orders from the Association as are not filled by members.

7. An associate member may become a member by subscribing and paying for, at par, the required number of shares of the Association.

2. Immediately after the annual meeting of the members the trustees shall meet and organize.

3. Special meetings of the members may be called by either the President or the Managing Director, and shall be called by the President upon written request of any five members. Five days' written notice of such meetings shall be given to the members by letter or wire.

4. Special meetings of the Board of Trustees, or of the Executive Committee hereinafter provided for, may be called by the President or Managing Director upon three days' written notice by letter or wire.

5. Notice of meetings of members, or of the Board of Trustees, or of the Executive Committee, may be waived in writing.

6. At all meetings of members, whether annual or special, no member shall be entitled to more than one vote, irrespective of the number of shares owned by it. At any annual or special meeting of the members a written vote received by mail from any absent member, signed by such member, may be read in such meeting and shall be equivalent to a vote of each of the members so signing, provided such member has been previously notified in writing of the exact motion or resolution upon which such vote is taken and a copy of same is forwarded with and attached to the vote so mailed by such member.

Article V.

Board of Trustees

1. Each member shall be entitled to nominate and to have elected one trustee. The Board of Trustees shall manage the business of the Association. The Board of Trustees shall annually elect from the membership of said Board a President, a Vice President, a Secretary, and a Treasurer, and shall appoint a Managing Director, who shall not be a member of said Board. The offices of Secretary and Treasurer may be combined in one person. The Board of Trustees may require the Managing Director, Treasurer, and any Assistant Treasurer or Treasurers, or any other person in any fiduciary capacity, to furnish a bond in such amount as the Board of Trustees may decide.

2. A majority of the members of the Board of Trustees present at any meeting shall constitute a quorum, but no trustee may be represented at any meeting by proxy.

3. The Board of Trustees may appoint an Executive Committee composed of six of the trustees, including the President, Vice President, and Secretary; and such Executive Committee shall possess and exercise, by a majority of all of its members, all the powers and duties of the Board of Trustees when the Board shall not be in session, except to the extent that such powers and duties may be, from time to time, limited by resolution of the board.

Article VI

President

The President shall hold office for the period of one year and until his successor is elected. The President shall preside at all meetings of the members and of the Board of Trustees and of the Executive Committee. The President shall be elected from the membership of the Board of Trustees. He shall sign and execute such legal documents as are authorized by the Board of Trustees.

Article VII

Vice President

The Vice President, in the absence of the President, shall perform the duties of the President.

Article VIII.

Secretary

The Secretary shall attend and keep minutes of all meetings of the members, and of the Board of Trustees, and of the Executive Committee. Under the direction of the Board of Trustees, or the President, he shall affix the seal of the Association to any legal instrument requiring the same. He shall have charge of the stock records and stock certificates, and in general perform all the duties incident to the office of Secretary, subject to the orders of the Board of Trustees.

Article IX.

Treasurer

The Treasurer shall have custody of all the funds and securities of the Association which may have come into his hands. When necessary or proper he shall endorse on behalf of the Association, for collection, checks, notes, and other obligations, and shall deposit the same to the credit of the Association in such bank or banks or depository as the Board of Trustees or the Executive Committee may designate. He shall sign all receipts and vouchers for payments made to the Association. Jointly with such other officer as may be designated by the Board of Trustees or the Executive Committee, he shall sign all checks made by the Association, and shall pay out and dispose of the same under the direction of the Board of Trustees or the Executive Committee. He shall sign, with the President or such other person or persons as may be designated for the purpose by the Board of Trustees or the Executive Committee, all bills of exchange and promissory notes of the Association. Whenever required by the Board of Trustees or the Executive Committee, he shall render a statement of his cash account. He shall enter regularly in books of the Association to be kept by him for the purpose, full and accurate account of all monies received and paid by him on account of the Association. He shall at all reasonable times exhibit his books and accounts to any trustee of the Association upon application at the office of the Association during business hours. He

shall perform all acts incident to the position of Treasurer, subject to the control of the Board of Trustees or the Executive Committee. The Board of Trustees or the Executive Committee may appoint the Managing Director Assistant Treasurer. The Managing Director may also appoint, subject to the approval of the Board of Trustees or the Executive Committee, one or more assistant treasurers, to whom may be delegated the above duties.

Article X.

Managing Director

The Managing Director shall be the executive head of the Association. He shall have general and exclusive charge and management of its business, subject to the control of the Board of Trustees, and of the Executive Committee. The Managing Director shall appoint the personnel of the office and be responsible for the management thereof. He shall carry out the policies laid down by the Board of Trustees, or the Executive Committee, but neither the Board of Trustees, nor the Executive Committee, nor any member of either the Board or the Committee, shall interfere in personnel matters. The salary of the Managing Director shall be fixed by the Board of Trustees. The Managing Director shall not be engaged in any outside business. If, under any circumstances, the Managing Director during his service shall obtain from any source any compensation, commission or consideration for his services in the plywood business, such compensation, commission

or consideration shall be turned into the Association. The Managing Director shall be employed on a one-year renewable contract. The Managing Director is authorized to sign any contract in the name of the Association if these contracts involve routine matters in the operation of the Association, including the hiring of members of the staff and other services, supplies, and rent, and any contract involving obligation of the Association specifically authorized through action of the Board of Trustees, or the Executive Committee.

Article XI.

Allocation and Distribution of Orders

1. The Allocation Schedule shall be fixed in advance at the annual meeting of the Board of Trustees and shall be in force for one year. In the event that increased or decreased capacity occurs during the allocation period in a plant owned or controlled by a member of the Association, such member may make application to the Board of Trustees for an adjustment in its schedule. Such increase or decrease in the allocation schedule shall be determined by the unanimous consent of the Board of Trustees. In the event it cannot be determined by unanimous consent, it shall be submitted for determination and decision to a board of arbitration, as elsewhere in these by-laws provided. Any such adjustment in allocation upon becoming effective shall be adjusted pro rata according to the existing percentages at the time, including the existing percentage of the member to whom additional

or decreased allocation of business is given. Should new members join the Association during the period the allocation is in effect, the Association shall determine, by two-thirds vote of the Board of Trustees, allocation of a certain percentage of the business to such new member or members, and the percentage so allocated shall be adjusted pro rata according to the existing percentages at the time. The allocation of business herein contemplated refers to all Western softwood plywood, whether cold-press or hot-plate. It is understood, however, that any plywood specialty items for export manufactured by any member, whether hardwood or softwood, may be sold by the Association on terms and conditions to be arranged with the producing mill, but such items shall not be included in the allocation schedule.

2. The allocation period with respect to orders shall be quarterly, according to the calendar year. At the end of each quarter, allocation of orders shall be closed and a new allocation period started without any carry-over from the previous period.

Article XII.

Quota

Each member shall be entitled to receive, from time to time, orders in accordance with the allocation schedule. The member shall accept and fill the order handed it by the Managing Director, and if in any instance the member declines to fill the order, the order thus declined shall be charged against

and be a part of said member's quota. Upon such declination the Managing Director shall have the order filled by some other member or members, but if all the other members decline said order, the Managing Director may have the order filled by an associate member.

Article XIII.

Tentative Commissions and Return of Excess

1. The Association shall charge and shall be entitled to receive as commission a percentage figured on the minimum price as shall be from time to time decided by the Board of Trustees or the Executive Committee. Said percentage of commission shall be deemed tentative merely and not final, subject to the provisions of paragraph (2) and (3) of this Article. The percentage shall be uniform and the same on all orders placed by the Association with the several members or associate members during a given period of time to be fixed by the said Board of Trustees or the Executive Committee.

2. It is not the purpose of this Association to make a profit; and the commission charged and remuneration received by the Association shall be the cost of transacting its business as sales agent, plus the cost of developing new foreign markets.

3. If during any fiscal year the total commissions and remuneration received by this Association in such fiscal year exceeds the amount that has been incurred during said fiscal year for the payment

by the Association of its expenses, including the cost of market development, then, unless the Board of Trustees by resolution shall direct otherwise, the Treasurer shall, before closing the books as of the close of said fiscal year, return or credit such excess to the accounts of the respective members and associate members, as an addition to the purchase price of the merchandise sold by them, in such proportions as the amount of square footage ($\frac{3}{8}$ " rough basis) of the orders filled by each member or associate member during such fiscal year bears to the amount of square footage ($\frac{3}{8}$ " rough basis) of the total orders filled by all members and associate members during such fiscal year.

Article XIV.

Trade Development

It is the purpose of the Association to improve the plywood export business in foreign countries, expand existing markets, and open up new markets. To that end the Board of Trustees or the Executive Committee shall fix the Association's commission so as to provide adequate amount to be expended in the promotion and development of new foreign markets, and is authorized to expend the same to develop new foreign outlets and to strengthen the position in established markets; to represent the export industry in dealing with federal and local authorities in questions pertaining to the export trade; to bring about uniform and efficient marketing methods, handle claims, and inform its members

in regard to foreign marketing and competitive conditions; to allocate export orders with the view of making the business profitable and at the same time securing the widest possible distribution; to negotiate with foreign organizations or agents, importers and plywood manufacturers in matters of mutual interest; to develop for its members designs and patterns and to assist in developing technical improvements in present methods affecting the manufacture of export products; and to acquire patent rights for the use of its members.

Article XV.

Trade-mark

The Association may adopt its own trade-mark if this is considered desirable by the Board of Trustees.

Article XVI.

Right of Visitation

Each member hereby authorizes the Association to audit the export business of such member, and to that end to have free access to all of the records, files, books of entry and account of each member. The audit shall be made by person or persons not directly connected with the plywood business.

Article XVII.

Arbitration

The annual allocation, if arbitration is necessary,

shall be arbitrated in accordance with the rules of the American Arbitration Association.

Any member dissatisfied with the Managing Director's distribution of orders shall be entitled, within five days after the distribution is announced, to file the complaint in writing, specifying the issue complained of, in which event the issue shall be arbitrated, and the rules of the American Arbitration Association shall apply.

Article XVIII.

Foreign Tariffs

The Association may, at the cost of the Association, represent the membership in obtaining reciprocal and lower foreign tariffs, or in shipping, transportation, or any matters whatsoever having to do with the exportation of plywood.

Article XIX.

Liquidation

Upon the dissolution of the Association, either by voluntary action or upon the expiration of the time of existence of the Association, if not extended by amendment of the Articles of Association, there shall be prompt liquidation of its assets. To that end, the Association shall surrender to the several members any rights claimed by it to the use of the trade-marks severally owned by the members. The assets of the Association shall all be converted into money, which shall be distributed among the members of the Association as follows:

(a) The shares of capital stock of the Association held by the members shall be redeemed at par if there is sufficient money to do so. If not, the money available shall be applied equally per share.

(b) If the money on hand is more than sufficient to redeem at par all of the outstanding stock, then after such redemption the remainder shall be distributed among the then members of the Association, based upon the proportion which the total amount of orders filled by each such member since the Association was organized bears to the total of all such orders of all of the members at the time of such dissolution.

Associate members shall not be entitled to participate in any of the assets of the Association on its dissolution.

Article XX.

Notwithstanding anything contained in these by-laws, Pacific Forest Industries shall not:

(a) In its by-laws, contracts with members or associate members, or otherwise, prohibit its members or associate members from selling plywood directly to American exporters, and all by-law and contract provisions to that effect, if any, are hereby rescinded and shall be deemed to be inoperative and void.

(b) Prevent its members and associate members from accepting and filling orders for plywood for export received by them, respectively, from American exporters, without reference to or approval by the Association.

(c) Impose any penalties, forfeitures, or charges upon sales of plywood by its members or associate members to American exporters, or fix or prescribe prices, terms, or conditions of sales to or by American exporters of plywood produced by its members, or take any other action designed to prevent or restrict such sales.

(d) Advertise in foreign countries that it is the sole export representative of the plywood mills in the United States Pacific Northwest, or make any advertising claims to the effect that United States Douglas fir plywood can be purchased in foreign countries only through Pacific Forest Industries and its agents.

For the purposes of this by-law the term "American Exporter" is defined as a citizen of the United States, a partnership in which the partner or partners owning the principal beneficial interest is or are citizens of the United States, or a corporation domiciled in the United States, the majority of the stock of which is owned by citizens of the United States, desiring to purchase plywood for his, their, or its own account for resale in export trade.

Article XXI.

These by-laws may be amended at any annual or special meeting of stockholders by a two-thirds vote of the members attending the meeting, if a quorum be present.

JOINT EXHIBIT 5-E

SPPDB

War Department, Office of the Under Secretary,
Washington, D. C., Price Adjustment Board

January 15, 1943.

Pacific Forest Industries,
Tacoma, Washington.

Gentlemen:

On December 18, 1942, we wrote to your company a letter, a copy of which is hereto attached. No response has been received. With the thought that this failure may be the result of an oversight, we call it to your attention with the request that you let us hear from you promptly.

Yours very truly,

/s/ HARLEY C. STEVENS,

Major, A.U.S.,

Executive Officer.

Room 3D 614

Pentagon Building

(C o p y)

SPPDB

Budget Bureau No. 49-R019-42

Approval Expires 3-31-43

War Department, Office of the Under Secretary,
Washington, D. C., Price Adjustment Board

December 18, 1942.

Pacific Forest Industries,
Tacoma, Washington.

Gentlemen:

Pursuant to the provisions of Section 403 of Sixth Supplemental National Defense Appropriation Act of 1942, as amended, Price Adjustment Boards have been established by the War Department, the Navy Department, the Treasury Department, and the Maritime Commission. The function of these Boards is to conduct renegotiation proceedings with individuals or corporations who are parties to contracts with the said Departments and Commission, or are performing subcontracts thereunder. The objective of such proceedings is to lead to a clearance of the companies under the Section of the Act above mentioned.

It is the general policy of the Boards that the renegotiation proceedings be conducted by the Department or Service having the predominant interest in the business of the respective companies. In the case of companies having one or more subsidiaries, renegotiations are usually conducted on a consolidated basis by which the war contracts of both parent and subsidiary companies are considered at the same time. These policies are designed to minimize inconvenience to the contracting companies as well as to promote an efficient procedure by the Boards.

In order that your company and its affiliates, if any, may be assigned for renegotiation to the proper Department or Service with the minimum of inconvenience to all concerned, we will be glad to receive any information which you may care to submit

bearing upon the matter. Such information should cover the following subjects:

a. Your estimate of the total dollar amount of the direct (prime) contracts which your company has with (1) the War Department, (2) the Navy Department, (3) the Treasury Department, (4) the Maritime Commission. With respect to your contracts with the War Department, you should indicate how the same are divided between the several Services of Supply and the Army Air Forces.

b. Your estimate of the dollar amount of the subcontracts which you are performing. This information should also be subdivided between Departments and the Army Services as requested in paragraph (a) above. In the event that it is not readily possible to divide the subcontracts between the Departments and Services, a statement by you of the principal products furnished under such subcontracts will be helpful for the present purposes.

c. The dollar amount of the expansions of your industrial facilities (plant or equipment) which have been financed by Government agencies. These should include facilities fully or partially completed and indication should be given as to the Department of Service, if any, sponsoring same.

d. A statement as to whether your company is the parent or subsidiary of another company and the percentage of ownership. In case your company has such affiliates, the information outlined in this letter should be submitted by or for each of them. This is proposed so that, if deemed desirable, the companies may be assigned for renegotiation simul-

taneously to the same Department or Service, and that renegotiation proceedings may be conducted on a consolidated basis.

We enclose for your convenience a suggested outline of reply. It is requested that such reply be forwarded to us in triplicate and that a separate reply be made by or for each affiliated company.

The difficulty of giving promptly an exact statement of the matters above mentioned is recognized. Accordingly, it is to be understood that a general estimate with respect to the amounts of contracts and subcontracts will suffice for the immediate purpose. Such information will in any case be received without prejudice to you.

The assignment of your company will be deferred for fifteen days following the date of this letter in order that you may have an opportunity to submit the information outlined above.

Yours very truly,

HARLEY C. STEVENS,

Major, A.U.S.,

Executive Secretary.

To: Assignment Section

Price Adjustment Board

War Department

Room 3D614 Pentagon Building

Arlington, Va.

Date

Gentlemen:

In reply to your inquiry,
we would advise as follows:

We estimate that the supply contracts (including subcontracts) of this company total \$..... and are divided as indicated below. We also indicate the amount of "facility expansions" financed by the Government and the agency which sponsored them:

	Supply Contracts		Publicly Financed
	Prime	Subcontracts*	Facility Expansions
Navy Department
Maritime Commission
War Department:			
Materiel Command, Army Air			
Forces, Services of Supply
Chemical Warfare Service
Corps of Engineers:			
Construction Division,			
Supply Division
Ordnance Department
Quartermaster Corps
Signal Corps
Surgeon General
Transportation
Treasury Department
Unclassified

(* If impossible to divide subcontracting business between Department and Services, state value and nature of product.)

The corporate relationships of this company are as follows:

(Give parent company, if any, and subsidiaries, if any, together with the approximate amount of intercompany ownership and any comments desired to be made as to practicability of renegotiation on a consolidated basis.)

Our current fiscal year ends.....

The foregoing information is based on general estimates only. Its purpose is to indicate to you our view as to how this company and its affiliates should be assigned for renegotiation under Section 403 of Public Law No. 528, as amended, should such renegotiation be required.

.....,

Name of Company.

(N.B. This reply should be in triplicate. Replies on behalf of affiliated companies should be made simultaneously.)

JOINT EXHIBIT 6-F

Pacific Forest Industries
Exporters of Plywood

Tacoma, Wash., U. S. A.

April 24, 1943.

Dear Sirs:

We are pleased to enclose Credit Memorandum to cover price adjustment on orders supplied by you and shipped by us during the period April 1st,

1942, through March 31st, 1943. The amount represents slightly more than the 6% commission deducted by us when settling your invoices. This means that P.F.I. business during the past fiscal year was handled at no expense to you and we hope to be able to continue on this basis.

May we point out, however, that the Treasury Department has filed with us a request for renegotiation of the contracts which we have accepted and are filling. It is, therefore, impossible to distribute the additional price evidenced by the enclosed Credit Memorandum until the results of the renegotiation are known. We believe, however, that the results will be favorable since, in the first place, we are a non-profit organization and, secondly, all plywood which we have shipped has gone outside the Continental United States and thus the contracts should not be subject to renegotiation under the law.

Yours very truly,

PACIFIC FOREST
INDUSTRIES.

HCR:dmh

enc.

The above letter sent to the following:

Wheeler Osgood Sales Corp.

West Coast Plywood Co.

Washington Veneer Co.

Vancouver Plywood & Veneer Co.

United States Plywood Corp.
Smith Wood Products, Inc.
Simpson Industries, Inc.
Robinson Manufacturing Co.
Oregon-Washington Plywood Co.
M & M Wood Working Co.
Donald W. Lyle
Harbor Plywood Corp.
Evans Products Co.
Elliott Bay Mill Co.
Buffelen Lbr. & Mfg. Co.
Bellingham Plywood Corp.
Associated Plywood Mills
Anacortes Veneer, Inc.
Aberdeen Plywood Corp.

JOINT EXHIBIT 7-G

(Copy)

Treasury Department
Procurement Division
Washington

Office of the Director

June 4, 1943.

Pacific Forest Industries
Tacoma, Washington

Gentlemen :

Reference is made to your letter of April 24, 1943, in which you state that Pacific Forest Industries is exempt from income tax payments through the Board of Tax Appeals in Docket No. 99742 dated November 4, 1941.

After a review of the Docket mentioned Procurement Division's Legal Staff has advised that the opinion rendered by the Board of Tax Appeals in this case only indicates a certain sum of money received by the contractor from its producer mills for the purpose of reducing an operating deficit incurred in its prior fiscal year was excludable from gross income for that taxable year. Hence, it appears that the Docket opinion is no basis to exempt your company. Consequently, I am directed to require that your accounts be renegotiated.

There have been received your balance sheets for the fiscal years ending March 31, 1936, through 1942. The information furnished, however, is not in sufficient detail to enable the Board to develop the necessary factual data required.

Since my letter of April 3 the enclosed mimeographed sheet has been issued showing the detail required. It will, therefore, be appreciated if you will furnish this information in the detail set out at your earliest opportunity.

As the balance sheets have not been certified to by a public accountant, they are returned for the purpose of having each of the statements sworn to by your treasurer or other accountable officer of

your firm. When these sheets are returned they should be accompanied by an analysis of the following:

Agents' commissions

Financing allowance

Exporters' commission

Traveling expenses

Trade Extension in Latin America

Cartons

It is hoped that by this effort to get all necessary data by mail, to be able to cut meetings with your firm and the Board to a minimum.

Very truly yours,

/s/ H. C. MAULL, JR.,

Chairman, Treasury Department Price Adjustment Board.

Enclosures

(Copy)

Information to Be Furnished for Fiscal Years
1941 and 1942 to Extent Applicable

1. History of Business

- (a) Brief corporate history
- (b) Normal peacetime products
- (c) Conversion to wartime
- (d) Conversion completed
- (e) Conversion contemplated

- (f) Location and brief description of plants
 - (1) Which devoted to war work
 - (2) Percentage of total production
- (g) Nature of Operation and degree of intergartion
- (h) Extent to which
 - (1) Prime contractor
 - (2) Subcontractor
- (i) List of subcontractors with \$100,000 or more of business on an annual basis
- (j) List of principal suppliers with dollar amount of purchases

2. Ownership and Affiliations

- (a) History
- (b) Principal stockholders
- (c) Intercorporate relations
- (d) List of subsidiaries or affiliates giving:
 - (1) Percentage of ownership
 - (2) Nature of business
 - (3) Whether or not consolidated tax return

3. Price and Production Record

- (a) Voluntary price reductions identified by contracts and expressed as to units and total dollar amount in 1942 and projected into 1943

- (b) Competitive price position
- (c) General statement as to performance under contracts as a whole
- (d) Special work in product development, assistance to Government, other contractors and availability of patents to others
- (e) Special risks inherent in the business beyond the company's control

4. Financial Assistance by Government

- (a) Through what source—War Department, Defense Plant, Reconstruction Finance Corporation, etc.
- (b) Nature of assistance
 - (1) If for physical facilities, brief description of nature, when commenced and when in operation, percentage of total volume handled

5. Plant Facilities Financed by Company

- (a) Source of funds
- (b) Cost and brief description
- (c) Percentage of War production to total production
- (d) Extent to which covered by Certificates of Necessity

6. Break-down of Business as between Renegotiable and Non-Renegotiable

- (a) Basis of break-down
- (b) Orders or contracts completed and paid in full prior to April 28, 1942
- (c) Full development of and reasons for allocation of manufacturing expense, factory burden, depreciation, amortization of emergency plant facilities, advertising, selling and general administrative expense, between the two classes of business. See Instruction Sheet for Filing Financial Data and "Joint Statement Etc."

7. Cost Plus Fixed Fee Business

- (a) Not to be included in sales figures but to be indicated separately

8. Subcontract Costs

- (a) Amount included in cost of government sales for finished or partly finished products purchased from others.
- (b) Other substantial material costs

9. Compensation

- (a) Current salaries (including bonuses separately) to each of the principal executives (\$10,000 or more per year) compared with years 1939 through 1941.
- (b) Bonus plans

- (c) Stock purchase or option plans
- (d) Insurance plans
- (e) Employee compensation
- 10. Extraordinary Reserves
 - (a) Reason therefor, amount and nature of risk
- 11. Breakdowns—(In the event the following items are shown in summary form in the auditor's report)
Detailed breakdown of—
 - (a) Cost of goods sold
 - (b) Selling Expenses
 - (c) Administrative and General Expenses
(42969)

JOINT EXHIBIT 8-H
Treasury Department
Procurement Division

Washington 25

Office of the Director

June 15, 1943.

Pacific Forest Industries
Tacoma, Washington

Gentlemen:

Reference is made to letter from this office dated June 4, 1943, requesting certain data regarding the renegotiation of your Government contracts.

To date no reply has been received, and it will be appreciated if you will assemble the information and have it reach me at an early date.

Very truly yours,

/s/ H. C. MAULL, JR.,

Chairman, Treasury Department Price Adjustment
Board.

JOINT EXHIBIT 9-I

McMicken, Rupp & Schweppe
Attorneys and Counselors at Law
657-671 Colman Building
Seattle, Washington
(Zone 4)

Maurice McMicken—1940

Otto B. Rupp
Alfred J. Schweppe
Maurice R. McMicken
Bernard Reiter
J. Gordon Gose
John N. Rupp

March 30, 1944

Mr. Henry Relf
Pacific Forest Industries
Washington Building
Tacoma, Washington

Re: P.F.I. Renegotiation

Dear Henry

Enclosed herewith is a memorandum from our Mr. Stoneman, covering the above subject. We shall continue to follow the matter closely.

As respects the fiscal year April 1, 1942, to March 31, 1943, it may be that the P.F.I. is in the clear after March 31st of this year. Whether it is or not depends on the application to the P.F.I. situation of the last paragraph of Section (c) (6), which provides that no renegotiation shall be commenced by the Secretary "more than one year after the close of the fiscal year of the contractor or subcontractor within which completion or termination of the contract or subcontract, as determined by the Secretary, occurs."

As to the fiscal year April 1, 1943, to March 31, 1944, filing of financial statements setting forth "such information as the board may by regulations prescribe" is now mandatory. For this, of course, we will have to await the regulations.

Yours very truly,

/s/ ALFRED J. SCHWEPPE.

(H. K.)

AJS:HK

March 28, 1944

Memorandum

To: Mr. Schweppe

From: Mr. Stoneman

Re: P. F. I. Renegotiation

From the accountant's weekly News Letter dated March 13, 1944, published by Prentice-Hall, Inc., it appears that the new War Contracts Price Adjustment Board, created by the recently amended Renegotiation Act, has held its first meeting, organized, and commenced the drafting of regulations to govern its procedure.

While material on the recent developments has not yet appeared in our services, the following paragraph is contained in the above-mentioned News Letter:

“The authority of the Board will be exercised over renegotiation proceedings covering contractor's fiscal years ending after June 30, 1943, while the Joint Price Adjustment Board which was established last October by voluntary action of the various individual departmental boards will supervise renegotiation proceedings covering fiscal years ended prior to and on June 30, 1943.”

(The order establishing the Joint Board is dated September 24, 1943, found at Par. 14, 371 C.C.H.; it is the O.W.I. release which was issued in October.)

Assuming, in advance of receipt of official word, that the above information is correct, we should look to the rules of the old Joint Price Adjustment

Board in determining our renegotiation procedure, if any, as to Pacific Forest Industries' fiscal year April 1, 1942-March 31, 1943, and to the rules of the new Board as to the fiscal year April 1, 1943-March 31, 1944. As to the latter year we have until the "first day of the fourth month following the close of the fiscal year" to file financial statements setting forth "such information as the Board may by regulations prescribe."

(Sec. (C) (5) (A))

I have written both to the new and the old Boards for copies of their regulations, which do not appear in the services, as a final determination cannot safely be made until they are examined. Preliminarily, I am approaching the problem for the prior year in the light of section (c) (6), of the Act, as it stood prior to the recent amendment, and for the latter year, in the light of the section as it now stands.

Before the recent amendment, the last paragraph of section (c) (6) read:

"No renegotiation of the contract price, pursuant to any provision therefor, or otherwise, shall be commenced by the Secretary more than one year after the close of the fiscal year of the contractor or subcontractor within which completion or termination of the contract or subcontract, as determined by the Secretary, occurs."

Paragraph (5) of the same section made it optional with the contractor to file financial and other statements.

As it now stands, section (c)(6) reads:

“This subsection shall be applicable to all contracts and subcontracts, to the extent of amounts received or accrued thereunder in any fiscal year ending after June 30, 1943, whether such contracts or subcontracts were made on, prior to, or after the date of the enactment of the Revenue Act of 1943; and whether or not such contract or subcontracts contain the provisions required under subsection (b), unless (A) the contract or subcontract provides otherwise pursuant to subsection (i), or is exempted under subsection (i), or (B) the aggregate of the amounts received or accrued in such fiscal year by the contractor or subcontractor and all persons under the control of or controlling or under common control with the contractor or subcontractor, under contracts with the Department and subcontracts including those described in clause (a), but excluding subcontracts described in subsection (a)(5)(B) do not exceed \$500,000 and under subcontracts described in subsection (a)(5)(B) do not exceed \$25,000 for such fiscal year. If such fiscal year is a fractional part of twelve months, the \$500,000 amount and the \$25,000 amount shall be reduced to the same fractional part thereof for the purpose of this paragraph.”

Reports are now mandatory, by the provisions of section (5)(A) from “every contractor and subcontractor who holds contracts or subcontracts to which

the provisions of this subsection are applicable," etc.

It may be that the fiscal year April 1, 1942-March 31, 1943, will not be renegotiable after March 31st, as that will be a year after the close of the fiscal year, and if this proves to be true no report will be necessary. However, it is not safe to come to any final conclusions until the situation is thoroughly reviewed in the light of the regulations which the Board has the power to make.

As respects the fiscal year April 1, 1943-March 31, 1944, a report to the Board will undoubtedly be required, as the aggregate of the amounts received or accrued during the year exceed \$500,000. Present information is that the report is to be submitted on the Board's own forms, request for which has been made.

From the time the report is filed, or the end of the fiscal year, whichever is the later, the Board has a year within which to commence renegotiation proceedings. If no such proceedings are commenced within that time, the contractor is discharged from all liability for excessive profits.

JOINT EXHIBIT 10-J

Pacific Forest Industries

Exporters of Plywood

Tacoma 2, Wash., U.S.A.

To the Stockholders of the P.F.I.:

The enclosed Balance Sheet and Statement of Operations cover the Pacific Forest Industries activ-

ities during the fiscal year ending March 31, 1944.

The operation of the P.F.I. shows receipts and expenditures to be in balance. Prior to the close of the fiscal year, the sum of \$303,630.45 was applied to the account of Adjustment of Mill Invoices in accordance with the by-laws. This figure represents a return of approximately 4% on the net mill invoices.

The settlement of outstanding Credit Memoranda is held up pending the P.F.I. renegotiation. A statement is being filed this month with the Price Adjustment Board of the Treasury Department which it is hoped will result in clearance.

An audit of the P.F.I. books is now in progress and a report will be submitted as soon as the audit is completed.

N. O. CRUVER,
Secretary-Treasurer.

May 4, 1944.

JOINT EXHIBIT 11-K
Treasury Department
Procurement Division
Washington 25

Office of the Director

June 21, 1944

Pacific Forest Industries
1219 Washington Building
Tacoma, 2, Washington

Gentlemen:

Upon review of the information submitted by you in connection with renegotiation under the Renegotiation Act, as amended, this office recommended to the War Contracts Price Adjustment Board that your assignment to this office for renegotiation be canceled for your fiscal year ending March 31, 1943.

This office is advised that such assignment has been canceled in accordance with its recommendation.

While such cancellation does not operate as a release of liability under the Renegotiation Statute, nevertheless, in the absence of further developments no further action is contemplated.

Very truly yours,

H. C. MAULL, JR.,

Chairman, Treasury Department Price Adjustment
Board.

Certified to be a true copy, 3/17/48.

McMICKEN, RUPP &
SCHWEPPE,

By /s/ WARREN A. DOOLITTLE.

JOINT EXHIBIT 12-L

Pacific Forest Industries

Exporters of Plywood

Tacoma, Wash., U. S. A.

June 26th, 1944

Mr. Alfred J. Schweppe

McMicken, Rupp & Schweppe

Colman Building

Seattle, 4, Washington

Dear Al:

Confirming telephone conversation, I am enclosing original of the letter received from Mr. H. C. Maull, Jr., and have taken a copy for our records. I thought perhaps the original might be interesting to you to show it is definitely a form letter. The information which we sent to Mr. Maull covered our fiscal year ending March 31st, 1944, and I am wondering if we should call this point to his attention or just await developments.

I should appreciate having your ideas on the subject at your convenience and with kindest regards, I am,

Sincerely yours,

HENRY,

H. C. RELF,

Manager.

HCR:dmh

Enc.

Certified to be a true copy, 3/17/48.

McMICKEN, RUPP &

SCHWEPPE,

By /s/ WARREN A. DOOLITTLE.

JOINT EXHIBIT 13-M

June 27, 1944

Mr. Henry Relf
Pacific Forest Industries
Washington Building
Tacoma, Washington

Re: Renegotiation

Dear Henry:

With reference to your letter of the 26th, enclosing the Treasury Department's form letter of June 21, 1944, since the Department has taken definite action "upon review of the information submitted by you," and "the information submitted by you" covered the fiscal year ending March 31, 1944, I do not believe their evident error in inserting "1943" in their form letter is of sufficient moment to require further correspondence. Your fiscal year ending as it does on March 31st, your report contained only three months of 1944, but nine months of 1943, and it is understandable how the reviewer of the file could easily make the error of inserting the wrong year. I believe you can safely close your file on the matter.

Sincerely yours,

ALFRED J. SCHWEPPE.

AJS:FB

Certified to be a true copy, 3/17/48.

McMICKEN, RUPP &
SCHWEPPE,

By /s/ WARREN A. DOOLITTLE.

JOINT EXHIBIT 14-N

June 27, 1944

Mr. Henry Relf
Pacific Forest Industries
Washington Building
Tacoma, Washington

Re: Renegotiation

Dear Henry

With further reference to the above subject, the Department's letter of June 21, 1944, as it says, is not a release, and your liability will not terminate until the statute of limitations has run, which in our opinion, if nothing further happens, will be a year from the date of the filing of your statement.

In my judgment, because the clearance from the Department is not absolute, the money should be withheld from distribution, at least unless released by the Executive Committee after a full review of the facts.

Sincerely yours,

ALFRED J. SCHWEPPE.

AJS:FB

Certified to be a true copy, 3/17/48.

McMICKEN, RUPP &
SCHWEPPE,

By /s/ WARREN A. DOOLITTLE.

JOINT EXHIBIT 15-O

Pacific Forest Industries

Exporters of Plywood

Tacoma 2, Wash., U.S.A.

May 4th, 1949

Messrs. McMicken, Rupp & Schweppe

Colman Building

Seattle, 4, Washington

Dear Sirs:

This is to inform you that as of May 4th, 1944, the date of the Secretary-Treasurer's report to the stockholders of the Pacific Forest Industries, Credit Memoranda covering the refund due the members of Pacific Forest Industries for the fiscal year ending March 31st, 1944, had been issued and mailed to the members.

Yours very truly,

PACIFIC FOREST
INDUSTRIES,

/s/ H. C. RELF,

Managing Director.

HCR:dmh

Filed T. C. U. S. June 14, 1949.

Before the Tax Court of the United States
Docket No. 20729

In the Matter of:

HARBOR PLYWOOD CORPORATION,
Petitioner,
vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

June 14, 1949, 10:00 A.M.

(met pursuant to notice.)

Before: Honorable C. P. LeMire,
Judge.

Appearances:

WARREN A. DOOLITTLE, ESQ.,
Appearing for the Petitioner.

WILLIAM E. KOKEN, ESQ.,
Appearing for the Respondent.

PROCEEDINGS

The Court: The Clerk will call the docket.

The Clerk: The Harbor Plywood Corporation,
Docket 20729.

The Court: Will the parties state their appearances for the record?

Mr. Doolittle: For the petitioner, the Harbor Plywood Corporation, Warren Doolittle.

Mr. Koken: William E. Koken for the respond-

ent.

The Court: Proceed with your opening statement.

Opening Statement on Behalf of the Petitioner
By Mr. Doolittle:

May it please the Court, as will be seen from the pleadings which are on file herein, this case presents a very simple question as to the time for the proper reporting of income by the petitioner Harbor Plywood Corporation. The income which is in question, if the Court please, consists of three separate refunds which were received by the petitioner Harbor Plywood Corporation from the Pacific Forest Industries, the corporation organized under the laws of the State of Washington, which is engaged solely in the export of plywood and other forest products, and in which the petitioner Harbor Plywood Corporation was, and still is for that matter, a stockholder; all that this court is called upon to determine is whether the amount of each credit memorandum constitutes a part of the taxable income of the petitioner Harbor Plywood Corporation, first, for the year in which each credit memorandum was issued by Pacific Forest Industries, as contended by the respondent Commissioner of Internal Revenue, which contention the taxpayer disagrees with, or, secondly, whether each credit memorandum constituted income for the year during which the Statute of Limitations expired on the re-negotiability of Pacific Forest Industries, or the third alternative, whether it constituted income to the petitioner Harbor Plywood Corporation for the

year in which each credit memorandum was paid in cash to the petitioner Harbor Plywood Corporation by Pacific Forest Industries.

Now, as the Court will see from the pleadings which are on file herein—and I suppose at this juncture I should invite the Court's attention to the fact that the original petition, pursuant to a motion and order granted by the court has been amended to set forth the petitioner's alternative contention, namely, that these credits did not constitute income to the petitioner prior to the expiration of the Statute of Limitations.

As the Court will see, the petitioner's main contention is that these amounts are not includible in income until such time as they were paid, or, in the alternative, until the period of limitations had expired on the re-negotiability of Pacific Forest Industries, whereas the Commissioner contends they were includible at the moment the memoranda were issued.

We will introduce a stipulation of fact which has been agreed upon with opposing counsel. We will object to the relevancy of Paragraph IX of that stipulation of fact, but we will introduce some additional testimony in support of the reasonableness of the threat of re-negotiations which hung over the head of the Pacific Forest Industries, and, in turn, hung over the head of the taxpayer Harbor Plywood Corporation.

The facts, as will be disclosed by the stipulation and the testimony are quite simple and not difficult to state. The Harbor Plywood Corporation

was in the business of manufacturing doors and plywood and other forest products, and had its place of business at Hoquiam. Its books were on the accrual basis, and the income was reported on the calendar year basis. The Harbor Plywood Corporation makes no sales in the export trade of its plywood. Their forest products, insofar as exports are concerned, are marketed by the Pacific Forest Industries. The Pacific Forest Industries is a co-operative organization organized under the laws of the State of Washington. As stipulated in the stipulation of facts, it is organized solely for the purpose of engaging in exporting plywood, as authorized by the Webb-Pomerene Export Trade Act. The Pacific Forest Industries, as will be seen from the stipulation, is a corporation under the laws of the State of Washington, and it is a stock corporation. The books of the Pacific Forest Industries are kept on the accrual basis, and its operations are reported on a fiscal year basis ending March 31 of each year.

The petitioner Harbor Plywood Corporation, at all times material to this action, as I stated previously, was a stockholder in the Pacific Forest Industries and was one of many stockholders.

This court is concerned with three credit memoranda which were issued to the petitioner and by the Pacific Forest Industries, which represented the petitioner's proportionate share of the refund of the excessive commissions charged the members of the Pacific Forest Industries during the Pacific Forest Industries' fiscal years ended March 31,

1943, March 31, 1944, and March 31, 1945. The date of each credit memorandum and the date of payment in cash by the Pacific Forest Industries is not in dispute, and, as set forth in the stipulation, the 1943 memorandum was paid in December, 1944; the 1944 memo was paid in cash in January of 1946, and the 1945 credit memo was paid in cash in July of 1946.

I would like at this time to inquire as to the Court's wishes. I don't wish to embark upon an argument, and I take it we will be allowed a brief time for argument.

The Court: There will be no oral argument.

Mr. Doolittle: All on briefs?

The Court: That is all taken care of in your brief.

Mr. Doolittle: I see. We will attempt to show, if the Court please, that Pacific Forest Industries, despite its repeated efforts to the contrary, was directed by the Treasury Department to file reports under the Re-negotiation Act, and it was informed and reinformed that it was subject to re-negotiation. The correspondence which is attached to the stipulation of facts, which will be filed, will show that the threatened re-negotiation of Pacific Forest Industries was actually a strong, continued and persistent threat, and, I take it, there will be no substantial controversy on that score.

We will also show by oral testimony that there were many conferences held by the Pacific Forest Industries with the Treasury Department Price Adjustment Board to free the Pacific Forest In-

dustries from the threat of re-negotiation. We will also show that the directors and the executive committee of the Pacific Forest Industries had no choice because of the threat of re-negotiation to delay the payment of the credit memoranda until the period of the re-negotiability of the P. F. I. had expired and, consequently, until the accounts receivable with the Government, with which the P. F. I. did business exclusively, until they were collected by the P. F. I., so that they might, in turn, pay to the taxpayer.

We will further show that the Petitioner Harbor Plywood Corporation had knowledge of this threatened re-negotiation of the P. F. I., and that it acquiesced in P. F. I.'s decision to delay the payments of these credit memoranda until the period of limitation on re-negotiation of the P. F. I. had expired, and that, in turn, the taxpayer had every reason to delay the reporting of these amounts until such period had expired. That, if the Court please, is a simple statement of the case. It is a question of the proper reporting of income by the Harbor Plywood Corporation, which income was first credited to it by the P. F. I. and was later paid.

OPENING STATEMENT ON BEHALF OF THE RESPONDENT

By Mr. Koken:

If the Court please, I will run over the facts rather hurriedly. The years involved are 1943, 1944 and 1945. The taxes involved are the excess profits taxes for the first two years, and the income

taxes for the last year. As stated by petitioner, counsel for the Harbor Plywood Corporation, the Harbor Plywood Corporation is an accrual basis taxpayer operating on the calendar year basis. It is a member of the Pacific Forest Industries, which is a cooperative association engaged in the exporting of plywood. It is customary among cooperative associations to return what are called excessive commissions to their members at the close of the fiscal year. The Pacific Forest Industries' fiscal year ends March 31. As of March 31, 1943, the Pacific Forest Industries issued a credit memorandum to the Harbor Plywood Corporation for some \$15,000.00 for its fiscal year ending March 31, 1944, it issued a similar credit memorandum in the sum of approximately \$33,000.00; and for the fiscal year ending March 31, 1945, it issued a similar credit memorandum, in the amount of approximately \$15,000.00.

The respondent determined that those credit memoranda constitute income of the petitioner Harbor Plywood Corporation for the year during which they were issued, and asserted deficiencies which are set forth in the notice of deficiency. The petitioner contended initially that these memoranda were not includible in income until they were actually paid in cash. The first one was paid in December, 1944, and was accordingly reported as income in that year by the petitioner. The last two were paid during 1946, and were reported in that year as income. I gather that the petitioner has retracted from its position that they are report-

able when paid in cash, and is now asserting an alternative argument, namely, that they are not includible in the petitioner's income in any event at any time prior to the expiration of the re-negotiability of the Pacific Forest Industries. It is the respondent's contention that re-negotiability has absolutely no bearing on the accruability of the income of the Harbor Plywood Corporation, petitioner. However, in the light of the alternative contention now put forth by the petitioner, which is now incorporated in the pleadings, the respondent has adopted also as its alternative contention the position that, in any event the memorandum was included in the year during which the Statute ran on the re-negotiability of the P. F. I. You will find that the petitioner and the respondent have the same alternative contention. Should the Court hold that the alternative contention of either party would be proper, it would give rise to additional deficiencies and excess profits taxes in 1943 and 1944, and income taxes for 1945; and, as an additional measure, the respondent is prepared to answer on the amended petition asserting those increased deficiencies. The result of a decision of the Court that the memoranda are includible in the years during which the statute ran would be merely moving forward to the next succeeding year each credit memoranda, namely, the 1943 would be includible in 1944, the 1944 in 1945, and the 1945 in 1946.

I would like to offer the stipulation of facts.

Mr. Doolittle: If it may please the Court, subject to the right of the petitioner to object to the

relevancy of Paragraph IX of the stipulation of facts; and we wish at this time to make objection to the Court to the admissibility of Paragraph IX of the stipulation of facts on the ground that it is irrelevant. Such paragraph IX has to do with the manner of reporting these credit memoranda by Pacific Forest Industries on its books of account, and the petitioner taxpayer, Harbor Plywood Corporation, respectively submits that the manner of the P. F. I. accounting in the books of account is not in issue, and is not before the Court at this time, and is irrelevant and inadmissible.

Mr. Koken: May it please the Court, I believe that is a very strange objection for the reason that the petitioner's entire argument is based upon the re-negotiability of the other organization, the Pacific Forest Industries, whose records reflect the manner in which they, that is, the Pacific Forest Industries, treated these very credit memoranda. Their very case is based upon the re-negotiability of that organization. It seems strange they should object to one phase of the record of that organization and endeavor to base their case on other activities of the organization. It is most relevant.

The Court: The objection will be overruled at this time. The Court can always disregard the paragraph in any event if it finds that it is not relevant.

Mr. Koken: There are fifteen joint exhibits in the stipulation.

The Court: They are all numbered?

Mr. Koken: Yes, they are.

The Court: And they will be considered in evidence as joint exhibits?

Mr. Doolittle: Yes.

The Court: Very well, they will be received in evidence as Joint Exhibits 1-A to 15-O.

(The documents above referred to were marked and received in evidence as Joint Exhibits No. 1-A to 15-O, inclusive.)

Mr. Koken: I would like to put in evidence as Joint Exhibit 16-P the minutes of the meeting of the executive committee of the Pacific Forest Industries held on April 20, 1943.

The Court: That will be a joint exhibit?

Mr. Doolittle: Yes.

The Court: That will be Joint Exhibit 16-P, and it will be received in evidence.

(The document above referred to was marked and received in evidence as Joint Exhibit No. 16-P.)

JOINT EXHIBIT 16-P

Pacific Forest Industries

Exporters of Plywood

Tacoma 2, Wash., U.S.A.

April 20th, 1943.

Executive Committee

Messrs. Frost Snyder

T. B. Malarkey

N. O. Cruver

Philip Garland

E. E. Westman

CC—Mr. Alfred J. Schweppe

Minutes of Meeting

A meeting of the Executive Committee was held at the P.F.I. Offices on Tuesday, April 20th, 1943, at 9:15 a.m.

Present were: Frost Snyder, N. O. Cruver and Philip Garland.

Also present were: Alfred J. Schweppe and H. C. Relf.

Absent: T. B. Malarkey and E. E. Westman.

There was first discussed the P.F.I. financial position. A preliminary Balance Sheet and Statement of Operations for the fiscal year ending March 31st was submitted. The statements showed excess receipts over expenditures for the fiscal year ending March 31st, 1943, of \$161,998.58. The P.F.I. Management was instructed to distribute this excess in the usual manner provided by the by-laws in the shape of credit memoranda for each mill's proportion of the overage in accordance with the footage shipped to P.F.I. The management was also instructed to send a letter to the members pointing out the very favorable results of the past fiscal year's operation.

There next was discussed the question of a change in the commission to be deducted by the Pacific Forest Industries from mill invoices and it was moved by Mr. Cruver and seconded by Mr. Garland that effective April 1st, 1943, the commission be reduced to 2% until further notice. Motion was unanimously carried. The management was in-

structed to notify all mills of this change in commission percentage.

The next subject for discussion was a proposed brief submitted by Culbertson & LeRoy of Washington, D. C., and which was to be filed with the War Production Board, the Central Procurement Agency, the Treasury Procurement and the Bureau of Accounts and Supplies, Navy Department.

The purpose of this brief was to endeavor to counteract any move on the part of the Central Procurement Agency to take over the purchase of plywood for the Lend-Lease Division of the Treasury Department. The Committee was informed by the Management that on April 19th, the Lend-Lease Division of the Treasury Department. had secured a blanket release for approximately 60,000,000 feet of Hutment grade from the War Production Board in accordance with the terms and conditions of Limitation Order L-150-B. The Committee was also informed that there seemed to be no disposition on the part of the Treasury Department to change their methods of purchasing Lend-Lease plywood which was evidenced by their placing of the last contract totalling 155,000,000 feet with P.F.I.

It was moved by Mr. Garland and seconded by Mr. Cruver that Mr. Schweppe be instructed to write Messrs. Culbertson & LeRoy that it was deemed unnecessary and inadvisable to file a brief such as they proposed at this time. The motion was unanimously carried.

There next was brought up a request by the St. Louis Plywood Manufacturers, Inc., to use the P.F.I. standard fibreboard cartons in packaging plywood which they were supplying for export. It was proposed that the manufacturers would be willing to pay a royalty. After some discussion, the Management was requested to write Mr. Willis an exploratory letter to aid the Executive Committee to reach a decision with regard to the proposal.

There being no further business, the meeting adjourned at 10:00 a.m.

Approved:

N. O. CRUVER,
Secretary-Treasurer.

Filed T. C. U. S. June 14, 1949.

Mr. Koken: I would like to offer 17-Q, which is a record of the meeting of the Executive Committee of the Pacific Forest Industries held on June 29, 1943.

The Court: That will be joint Exhibit 17-Q, and will be received in evidence.

(The document above referred to was marked and received in evidence as Joint Exhibit No. 17-Q.)

JOINT EXHIBIT 17-Q

Pacific Forest Industries

Exporters of Plywood

Tacoma 2, Wash., U. S. A.

June 29th, 1943

Executive Committee

Messrs. Frost Snyder

Thomas B. Malarkey

N. O. Cruver

Philip Garland

E. E. Westman

Arnold Koutonen

CC: Mr. A. J. Schweppe

Minutes of Meeting

A meeting of the Executive Committee was held at the P.F.I. Offices on Tuesday, June 29th, 1943, at 9:10 a.m.

Present were: Frost Snyder, T. B. Malarkey, N. O. Cruver and Arnold Koutonen.

Also present were: B. V. Hancock, H. J. Nunneley, Alfred J. Schweppe and H. C. Relf.

Absent: Philip Garland and E. E. Westman.

The re-negotiation of P.F.I. contracts with Treasury Procurement was first discussed. Mr. Schweppe reported on his interview with H. C. Maull, Jr., Chairman, Treasury Department Price Adjustment Board at Washington, D. C., and also stated that the P.F.I. Management had prepared a complete statement with regard to its method of operations

as well as answering various specific questions raised by the Treasury Department. Mr. Schweppe stated that this statement was full and complete, had his approval and it was his opinion that after this statement was received by the Treasury Department, that any re-negotiation as far as P.F.I. was concerned, would be dropped.

The next item for discussion was the allocation of the W.P.B. Lend-Lease allotment. The P.F.I. management requested the committee to decide whether this business should be allocated as far as possible proportionately throughout the industry or should the present flexible method be followed whereby orders were placed to fit as closely as possible the manufacturing problems of each individual mill. The P.F.I. Management was instructed to continue placing this business on the flexible basis until such a time as the allotment was increased to a point where this method would not be practicable.

There next was discussed the request by Mr. Eric Lindblom of Weyerhaeuser Sales Co. to be given the P.F.I. export statistics for the years up to and including 1939. It was explained that Mr. Lindblom is working on a research project concerning the export trade in lumber and lumber products and that he could not secure from Government agencies full information with regard to plywood statistics. After some discussion, the P.F.I. management was instructed to give Mr. Lindblom the statistics he required.

A letter from the Steel Export Association of America, requesting a copy of the P.F.I. Articles of Incorporation and a copy of its by-laws was read to the Committee. It was moved by Mr. Cruver and seconded by Mr. Malarkey that these documents be furnished and that a copy of the Federal Trade Commission decision be also sent to the Steel Export Association of America for their comments.

The next item for discussion was the adjustment of the salaries of the P.F.I. personnel which the Board of Trustees at the Annual Meeting held on May 6th, 1943, turned over to the Executive Committee for action. Mr. Schweppe explained the situation with regard to Treasury Department approval required on any salary adjustments and after some discussion, it was moved by Mr. Malarkey and seconded by Mr. Koutonen that Mr. Cruver be appointed as a committee of one to make a recommendation to the Executive Committee with regard to these salary adjustments and, at the same time, to explore the possibility of securing the U. S. Treasury Department approval therefor. Mr. Cruver was also authorized to approve the payment of the bonus to P.F.I. executive personnel on a monthly basis instead of a quarterly basis if he deemed it advisable.

The P.F.I. Management informed the meeting that the W.P.B. allocation of 1 million Exterior type, 4 million Hutment type and 5 million Moisture Resistant type did not permit of an equitable

distribution of P.F.I. orders to the mills. It was reported that in a conversation with Mr. Walby concerning this division of types, it was found that it would be necessary for the Lend-Lease Section of Treasury Procurement to apply to the Requirements Committee for any changes. It was suggested by the Management that the following division of types would be preferable from all standpoints, i.e., 2,500,000 Exterior; 4,000,000 Hutment, 3,500,000 Moisture Resistant. It was moved by Mr. Malarkey and seconded by Mr. Cruver that the P.F.I. be instructed to start negotiations through the Lend-Lease Section of Treasury Procurement to have the allotment changed.

There being no further business, the meeting was adjourned at 10:05 a.m.

Approved:

N. O. CRUVER,
Secretary-Treasurer.

Filed T. C. U. S. June 14, 1949.

Mr. Koken: And as 18-R, the record of the minutes of the Executive Committee of the Pacific Forest Industries dated April 25, 1944.

The Court: 18-R is received in evidence.

(The document above referred to was marked and received in evidence as Joint Exhibit No. 18-R.)

JOINT EXHIBIT 18-R

Pacific Forest Industries

Exporters of Plywood

Tacoma 2, Wash., U. S. A.

April 25, 1944

Executive Committee

Messrs. Frost Snyder

Thomas B. Malarkey

N. O. Cruver

Philip Garland

E. E. Westman

Arnold Koutonen

CC: Mr. A. J. Schweppe

Minutes of Meeting

A meeting of the Executive Committee was held at the P.F.I. Offices on Tuesday, April 25th, 1944, at 9:20 a.m.

Present were: Messrs. Frost Snyder, N. O. Cruver, Philip Garland and Arnold Koutonen.

Also present were: Messrs. Nunneley, Schweppe and Relf.

Absent: Messrs. T. B. Malarkey and E. E. Westman.

A preliminary Balance Sheet and Statement of Operations for the fiscal year ending March 31st, 1944, were submitted. The Statement showed Excess Receipts over Expenditures of \$303,630.45. It was moved by Mr. Cruver and seconded by Mr. Koutonen that the action of the Treasurer, in accordance with the by-laws, in crediting such excess

to the accounts of the respective members as an addition to the purchase price of merchandise sold, before closing the books as of the end of the fiscal year, be approved. This motion was unanimously carried.

There was next discussed the status of the renegotiation of P.F.I. contracts with the Treasury Department. Mr. Schweppe reviewed the situation and stated that there had recently been submitted by Mr. H. C. Maull, Jr., Chairman, Treasury Department Price Adjustment Board, Washington, D. C., a request for statements covering the P.F.I. operations for the fiscal years ending March 31st, 1943, and March 31st, 1944. The management stated that these statements would be filed in the near future.

There next was discussed the continuing slowness of payment on the part of the Treasury Department, making it impossible to maintain payments to the mills within a reasonable period of time.

The management stated that there were two suggested ways of expediting payment to the mills, either by the use of bank credit or inserting a discount clause on the face of P.F.I. invoices. After some discussion, the management was instructed to continue exerting all possible pressure to expedite payment and that in the event substantial payments were not received within a period of two to three weeks, that this problem be again submitted to the Executive Committee for further action.

There being no further business, the meeting was adjourned at 9:55 a.m.

Approved:

N. O. CRUVER,
Secretary-Treasurer.

Filed T. C. U. S. June 14, 1949.

Mr. Koken: And 19-S, record of the minutes of the meeting of the Executive Committee of the Pacific Forest Industries dated November 30, 1944.

The Court: That will be received as Joint Exhibit 19-S.

(The document above referred to was marked and received in evidence as Joint Exhibit No. 19-S.)

JOINT EXHIBIT 19-S
Pacific Forest Industries
Exporters of Plywood

Tacoma 2, Wash., U. S. A.
November 30th, 1944

Executive Committee

Messrs. Frost Snyder

T. B. Malarkey

N. O. Cruver

Arnold Koutonen

R. E. Seeley

CC: Mr. A. J. Schweppe

Minutes of Meeting

A meeting of the Executive Committee was held at the P.F.I. Offices at 9:30 a.m., Tuesday, November 28th, 1944.

Present were: Messrs. Frost Snyder, T. B. Malarkey, N. O. Cruver and R. E. Seeley.

Also present were: Messrs. Schweppe, Kirk and Relf.

Absent: Arnold Koutonen.

The first item for discussion was a proposed exclusive agency agreement for the Republic of China with the China Plywood Company of Kunming, China. The terms of this agreement as well as the reasons for such an arrangement were fully discussed and it was moved by Mr. Cruver and seconded by Mr. Seeley that the exclusive agency be granted on the terms proposed. This motion was unanimously carried.

There was next discussed an exclusive agency arrangement for French Morocco, Spanish Morocco and Tangier with Messrs. Joseph S. Toletdano & J. M. Pinto S. A. R. L. of Casablanca. After some discussion, it was moved by Mr. Malarkey and seconded by Mr. Cruver that an exclusive agency for these territories be given to this firm. This motion was unanimously carried.

The next item for discussion was the payment of the credit memoranda issued to the mills covering the distribution of the overage for the fiscal year ending March 31st, 1943. The question of the status of the re-negotiation of P.F.I. for the fiscal years ending March 31st, 1943, and March 31st,

1944, was fully discussed and it was pointed out by Mr. Schweppe that P.F.I. had received only a conditional clearance and that it had been his recommendation that the funds be held and not distributed until May, 1945, especially with reference to the overage for the fiscal year ending March 31st, 1944. The Management informed the Committee that no statement had been requested by the Treasury concerning the operations of P.F.I. for the fiscal year ending March 31st, 1943, and that it had not been filed. The Committee was further informed that there was some question as to the operation of the Statute of Limitations relative to the re-negotiation of the business for that year. After thoroughly weighing the pros and cons of the matter, the Committee decided that there was a reasonable chance that there would be no re-negotiation for the fiscal year ending March 31st, 1943, and it was moved by Mr. Malarkey and seconded by Mr. Seeley that the Management be instructed to settle the credit memoranda covering the overage for the fiscal year ending March 31st, 1943.

It was moved by Mr. Cruver and seconded by Mr. Seeley that the annual Christmas bonus of one month's salary be given to the eligible P.F.I. employees. This motion was unanimously carried.

There being no further business, the meeting was adjourned at 9:56 a.m.

Approved:

N. O. CRUVER,
Secretary-Treasurer.

Filed T. C. U. S. June 14, 1949.

Mr. Koken: And Joint Exhibit 20-T, which is the corporation income excess profits tax return for the petitioner Harbor Plywood Corporation for 1943, and I should like to ask authority to substitute a photostatic copy.

The Court: Very well. Joint Exhibit 20-T is received in evidence, and permission is given to the respondent to withdraw the original and substitute a photostatic copy.

(The document above referred to was marked and received in evidence as Joint Exhibit No. 20-T.)

Mr. Koken: I would like to offer Joint Exhibit 21-U, which is the income and excess profits tax return of the petitioner involved for the year 1944, with the same request.

The Court: All right. Joint Exhibit 21-U is received, and permission is granted to withdraw the original and substitute a photostatic copy.

(The document above referred to was marked and received in evidence as Joint Exhibit No. 21-U.)

Mr. Koken: As 22-V, the corporation income, declared value and excess profits tax return for the petitioner Harbor Plywood Corporation for the year 1945, with the same request.

The Court: 22-V is received in evidence and permission is given to withdraw the original.

(The document above referred to was marked and received in evidence as Joint Exhibit No. 22-V.)

The Court: Are there any further exhibits to be offered at this time?

Mr. Doolittle: No further exhibits.

The Court: All right, proceed, and call your first witness.

Mr. Doolittle: Before calling our first witness, and having in mind our assurance to your Honor it would not take more than one hour, we think it best to invite your attention, if we may, to several exhibits attached to the stipulation of facts, by way of background to certain testimony which we intend to introduce.

The Court: Very well.

Mr. Doolittle: If I may, with Mr. Koken's and your permission. state these briefly, I believe it would make the balance of the testimony more understandable.

The Court: Very well, you may proceed.

Mr. Doolittle: First of all, we would like to invite your Honor's attention to 5-E, a letter dated January 15, 1943, from the Treasury Department Price Adjustment Board addressed to Pacific Forest Industries respecting re-negotiations proceedings, which letter briefly states, on December 18, 1942, "We wrote to your company a letter, a copy of which is hereto attached. No response has been received. It is possible that this may have been an oversight." And attached thereto is a letter of December 18, 1942, relative to re-negotiation of the Pacific Forest Industries, submitting certain data.

We also wish to invite your Honor's attention to Joint Exhibit 16-P and 17-Q, which are the min-

utes of the executive meeting of the Pacific Forest Industries, in which the subject of re-negotiation of the P. F. I. is discussed; and then we invite your Honor's more specific attention to Joint Exhibit 6-F, which is dated April 24, 1943. If it will please the Court, this is the letter of transmittal forwarding the first of the credit memoranda with which we are concerned. You will note that the second paragraph of that letter states as follows: "May we point out, however, that the Treasury Department has filed with us a request for re-negotiation of the contract which we have accepted and are filing. It is therefore impossible to distribute the additional portion evidenced by the enclosed memorandum until the results of re-negotiation are known. We believe, however, the result will be favorable, since, in the first place, we are a non-profit organization and, secondly, all plywood that we have shipped has gone outside of the continental United States, and this contract is not subject to re-negotiation."

I would like to invite your Honor's attention and the Government's counsel to Exhibit 7-G, which immediately follows, and particularly to the last sentence of paragraph II of that letter, which, as your Honor will see, is from the Chairman of the Treasury Department Adjustment Board, addressed to Pacific Forest Industries, and which makes reference in that first paragraph to P. F. I. previous correspondence requesting exemption from re-negotiation. It reads, "Consequently, I am directed to require that your accounts be re-negotiated."

I would like to also, if your Honor please, invite

your specific attention to Joint Exhibit 10-J. That exhibit is dated May 4, 1944, and has reference to the second credit memorandum with which this Court is concerned, namely, the one for the period ended March 31, 1944. As will be seen in Joint Exhibit 15-O, it is stated that the 1944 memo had been issued to the members shortly prior to this letter to the stockholders dated May 4, which is Exhibit 10-J.

You will note in the third paragraph of Exhibit 10-J, settlement of outstanding credit memorandum is held up pending P. F. I. re-negotiation. Statement is being filed which it is hoped will result in clearance.

I would like to also invite your Honor's attention to Joint Exhibit 3-C, one of the black photostats. That is the credit memorandum for the third year in question, 1945, and you will note that endorsed upon the face of that credit memorandum is the following endorsement: "This credit memorandum is subject to re-negotiation, and it is therefore not final."

I would like to invite your Honor's further attention to Joint Exhibit 19-S, the last exhibit ahead of the tax returns, and to the paragraph beginning at the bottom of the first page: This exhibit is dated November 30, 1944. I need not take your time at this time to read it in full, but there is to be found there further reference to a discussion by the executive committee concerning the payment in cash of the 1943 and the 1944 memoranda, and a discussion of the threatened re-negotiation of the P. F. I. and of the applicable statute of limitations on said

re-negotiation, the recognition of the threat of re-negotiation, and the resolution of the executive committee as set forth in the last portion of that paragraph appearing on page 2: After thoroughly weighing the pros and cons of the matter, the committee decided there was a reasonable chance there would be no re-negotiation for the fiscal year ending March 31, 1943, and it goes on to say that it was moved and seconded that the committee be instructed to make the payment for the fiscal year ended March 31, 1943. Your Honor will also see from the stipulation of facts that it was a few days after November 30, 1944, pursuant to that resolution, the credit memoranda were paid in cash.

If the Court please, subject to your Honor's permission, I have Mr. Koken's approval, I believe, to call Mr. Alfred J. Schweppe as a witness. Mr Schweppe has been the original counsel for the petitioner in this action, and he was and now is counsel for Pacific Forest Industries and for Harbor Plywood Corporation. He can testify of his own knowledge concerning the personal interviews with the Treasury Department Price Adjustment Board and his efforts to exempt the P. F. I. from re-negotiation, and he can testify of his own knowledge concerning the knowledge that the Harbor Plywood Corporation had, by virtue of his being their counsel and having informed them of the threats of re-negotiation. Mr. Koken has assured me in advance he has no objection, subject to your Honor's approval.

Mr. Koken: I think I should like to tell 'the

Court that while I have no objection to the competency of Mr. Schweppe, I am not in a very good position to object to the relevancy of the testimony that he will give, because of the alternative contention which we have made. Were it not for that alternative contention we would very definitely object to the testimony and all the exhibits included in paragraph XII of the stipulation.

The Court: Very well.

whereupon,

ALFRED J. SCHWEPPE

called as a witness for and on behalf of the Petitioner, having been first duly sworn, was examined and testified as follows:

Direct Examination

By Mr. Doolittle:

Q. Will you give your full name to the reporter?

A. Alfred J. Schweppe.

Q. Will you state your occupation?

A. I am an attorney-at-law, practicing in Seattle.

Q. Inviting your attention to the years 1943, 1944 and 1945, will you state your relationship to the petitioner Harbor Plywood Corporation at that time?

A. I was at that time and still am counsel for the Harbor Plywood Corporation.

Q. Directing your attention to those same years, what was your relationship, if any, to the Pacific Forest Industries?

(Testimony of Alfred J. Schweppe.)

A. I was also counsel for the Pacific Forest Industries.

Q. And still are? A. And still am.

Q. Will you please tell the court, what, if any, efforts you made as counsel for the Pacific Forest Industries during the years 1943, 1944 and 1945 to exempt Pacific Forest Industries from re-negotiation under the Re-negotiation Act?

A. As the evidence in the stipulation already to some extent shows, I made strenuous efforts to have the P. F. I. exempted from re-negotiation, believing that it was the type of institution that ought to be exempt under the re-negotiation statute. Those efforts consisted of a number of interviews in Washington, D. C. where I went on an average of every month or two during the war years. I called upon Mr. Mall, who was the head of the Treasury Department Procurement, and also Chief of the Re-negotiation Office for Treasury Procurement, and the Chief Counsel for Treasury Procurement. As shown by one of the exhibits, it turned out to be of no avail for the reason that the Treasury Department took the position that the only contracting parties that they knew was the P. F. I., and therefore they held the P. F. I. was re-negotiable, and they finally confirmed that in one of the exhibits in the stipulation.

The Pacific Forest Industries is a Washington corporation, organized to do business solely in export trade under the terms of the Webb-Pomerene Act, which has authorized American manufacturers,

(Testimony of Alfred J. Schweppe.)

for the purpose of doing business in export trade, subject to certain provisions in the statute, an exception under the Sherman Anti-Trust Act. The Pacific Forest Industries is such a Washington corporation, and it has as its members and stockholders some twenty or twenty-five plywood companies. I think the list is attached to the letter of April 24, 1943, which is one of the exhibits, which was addressed to all the then members of the P. F. I., transmitting a credit memorandum with a notation concerning re-negotiation.

Under the by-laws which are in evidence, the P. F. I. operates as a non-profit corporation, and at the end of the year all of its income in excess of operating expenses is credited to the members in accordance with the proportionate share of business they have done that year with the P.F.I.

The Re-negotiation Act was passed in 1942 and, of course, was a new legal concept on the horizon with which neither businessmen nor government officials were very familiar, because it gave the Government the right to negotiate contracts for war purposes in the event it was believed by the Government that the profit on the so-called re-negotiable portion of the Government's business was excessive.

The Pacific Forest Industries did business during the years in question exclusively with the Treasury Procurement, which, as we all know, and which one could take judicial notice of, made all the purchases that were publicly known as lend-lease pur-

(Testimony of Alfred J. Schweppe.)

chases. The plywood was purchased for lend-lease in Britain. The contracts throughout the period in question were between the P.F.I. and Treasury Procurement. They were negotiated, formal contracts relating to plywood for export to foreign countries, and the only contracting parties in those parties were the P.F.I. and the Treasury Department.

As shown in the evidence, the P.F.I. is a cooperative organization and returns to its members the excess over operating expenses each year.

Of course, when Congress enacted the Re-negotiation Act, it created a new condition, or attached a new condition to the doing of business by the passage of the Re-negotiation Act, and, as a result, the income of the business resulting from such contracts which were subject to re-negotiation could be held up, or some portion of it, because it was subject to re-negotiation. In consequence of that, lawyers advised their clients that that income was subject to re-negotiation, and could not be considered income unconditionally belonging to the corporation, and that they should guide themselves accordingly until the question of re-negotiation had been taken care of.

I made repeated attempts through my office, and in visits to Washington, to have the P.F.I. exempted, as I stated a few moments ago, but failed to do so.

Q. Mr. Schweppe, did anybody accompany you?

A. On one of the conferences there was Mr.

(Testimony of Alfred J. Schweppe.)

Relf, who was the manager of the P.F.I. At any rate, the final answer is in the file, and the final answer was that the P.F.I. was re-negotiable. I advised them therefore that this memorandum, which came along about March 31, 1943, the first one, should not be paid until the question of re-negotiability was taken care of.

Q. Did you inform the Harbor Plywood Corporation of such threatened re-negotiation?

A. The Harbor Plywood Corporation was probably advised as early as the P.F.I., for the reason that Mr. Daniels, who was the president of the Harbor Plywood Corporation, accompanied me to Washington many times during the war. We were both of us on many committees during the war period, and he and other plywood manufacturers were immediately informed of the re-negotiation question which attached, in my opinion, a condition to the payment of credit memoranda until the question of re-negotiation had been cleared up. Subsequently, as the record shows, I advised Mr. *Relf*, and the individual companies that, in my opinion, the credit memoranda could not be paid until either the re-negotiation had been actually had and disposed of or until the statute had run on the re-negotiation, as an examination of the statute showed that re-negotiation ran within the one year after the end of the fiscal year, and if no action was taken by the particular government agency which had the power to re-negotiate.

Mr. Doolittle: I might invite your Honor's at-

(Testimony of Alfred J. Schweppe.)

tention to Exhibit 14-N, attached to the stipulation, in which such advice was reduced to writing.

A. (Continuing.) The result of it was, because of the position of Treasury Procurement that the P.F.I. was the only contracting party, and that it did not know the members of the P.F.I., that P.F.I. was therefore re-negotiable, then the P.F.I. held up the payments of the credit memoranda until the question of re-negotiation was cleared up.

Speaking specifically of Harbor Plywood Corporation, Mr. Daniels and I went to Washington many times together, and I informed him, and he acquiesced and agreed, as did others, that the money should not be paid; they didn't want to take it into the accounts and later have to send it back so that the P.F.I. could meet the re-negotiation liability. So it was understood between the P.F.I. and the companies that the actual payments should be held up until the legal condition which the Government had attached to the payment by the P.F.I. should be removed.

Q. Did the action of the Executive Committee in delaying payment, as set forth in the letter to the members of April 24, 1943—was that action ratified by the Harbor Plywood Corporation?

A. Yes; as a matter of fact, not only by the members specifically agreeing that the money should be retained until the question should be cleared up, but that is borne out by the fact that the money was not actually paid, a great deal of it, until 1946 when the question was clearly out of the way.

(Testimony of Alfred J. Schweppe.)

There is another point I should testify to, because I knew it as counsel for the P.F.I., whose meetings I attended. I attended one at 9:30 o'clock this morning because Mr. *Relf* is going to Europe, and he called an emergency meeting for 9:30 o'clock, and that is the reason we could not be here at that time.

I think the record shows that the 1943 memorandum was not paid until December of 1944, and I think the 1945—the 1944 and 1945 memoranda were not paid, the 1944 one until January of 1946 and the 1945 memorandum until July of 1946.

There is a further factor that is lurking in the records, which is shown in the record, which I think I should mention. As I stated a moment ago, the only customer that the P.F.I. has had and done business with was the government of the United States, and the Government was characteristically slow in meeting its obligation. That is because there was a great deal of red tape, which had to be untangled, which there usually is.

Q. That reference is contained in Joint Exhibit 18-R, the minutes of the executive meeting of April 25, 1944.

A. So actually the fact is, and Mr. *Relf* will confirm it if it should become necessary to recall him, the further fact that the P.F.I. didn't pay the credit memoranda until the P.F.I. had the money to pay; so the only way they could pay the credit memoranda to the members, short of receiving payment from the Government, would be by going to

(Testimony of Alfred J. Schweppe.)

the banks. But they finally said, "We will take a chance on 1943." But the 1944 payment was not made until January of 1946, and the 1945 one was not paid until July of 1946, solely because short of assessing its members, and short of borrowing, the P.F.I didn't have the money to pay its members.

I will say that I have been a party to this from the beginning, and I think I state it realistically, with the question of re-negotiability hanging over the Pacific Forest Industries, with the Government asserting its claim, and with the Treasury Department taking its position as outlined with respect to re-negotiability, no counsel could afford to advise them to pay out the money before re-negotiation was had and disposed of, since they would have to re-assess their members in case of re-negotiation and necessity for such action.

Q. Calling your attention to Joint Exhibit 11-K, addressed to the P.F.I., dated June 21, 1944, in which it is stated, "While such notice does not operate as a release of your liability under the Renegotiation Statute, nevertheless, in the absence of further developments, no further action is contemplated." Did such a letter, or a copy thereof, ever come to your attention? A. Yes, it did.

Q. Did it form the basis of any opinion?

A. Yes, I think I rendered a written opinion. I think the decision is in the record, or the opinion, rather.

Q. Your letter giving that opinion is Exhibit 14-N? A. Yes.

(Testimony of Alfred J. Schweppe.)

Q. Dated June 27, 1944? A. That's right.

Mr. Doolittle: You may inquire.

Cross-Examination

By Mr. Koken:

Q. Since you wanted to take a realistic view of the situation, why didn't you advise the P.F.I., which, of course, is not the petitioner here, to issue the credit memorandum, or not to issue the credit memorandum?

A. Not to issue the credit memorandum?

Q. Yes?

A. The credit memorandum, under the by-laws, was automatically issuable every year. Under the by-laws the credit memorandum is automatically given to each member, and the credit indicated. I think the record shows that each member was advised at the time he received the credit memorandum, beginning with the first one, and was advised with regard to each one that it was subject to renegotiation, and therefore completely up in the air as to what, if any portion, would be paid. In other words, it was perfectly proper to advise, "Here is what you have coming unless the Government takes it away. We don't know whether they will take anything or not, or take it all."

Q. Suppose you had been counsel for either party and had been asked by the holder of one of the credit memoranda—I have reference to the first two—to advise whether they were enforceable. What do you think would be your advice?

A. Well, I would have to know all the circum-

(Testimony of Alfred J. Schweppe.)

stances. As I testified a moment ago, the moment that this question arose the individual members of the P.F.I. all acquiesced and agreed that the money would be held. I don't believe after that position had been taken that they were enforceable.

Q. In what way did they agree?

A. They didn't want to get any money that they might have to pay back. They were told—at least it was my legal theory, which conformed to the theory of the Treasury Procurement, that the credit on the books was subject to a legal liability of the P.F.I. Under the by-laws, these credit memoranda were to be issued every year as shown by the books, but since there was a liability, a legal liability, attached to the credit memoranda, they were not unconditionally payable.

Q. Didn't you consider that money as belonging to the various members?

A. It only belonged to the members if there was no expense charged back, because the only thing that the P.F.I. pays back to the members is what is left after all the legal liabilities and the expenses have been paid. To carry it further, if you sued the P.F.I., it would have to be upon the ground that the credit memorandum was unconditionally payable; but because Congress had attached a contingent liability, therefore you could not recover as long as that was an unliquidated claim.

Q. When the amounts were finally determined at the end of each fiscal year and set up on the books of the P.F.I. and a credit given to the petitioner Harbor Plywood Corporation, don't you

(Testimony of Alfred J. Schweppe.)

think that at that moment that became the money of the Harbor Plywood Corporation?

A. No; not in my opinion. In my opinion it became a conditional credit to the Harbor Plywood Corporation, subject to the determination of whether or not the P.F.I. didn't have the additional liability which it must first meet under the by-laws of the corporation.

Mr. Doolittle: I should like to interrupt to this line of questioning as calling for a number of conclusions of the witness, which are perhaps best answered by the Court. If he wishes to ask the witness about his expressing an opinion to the petitioner, the Harbor Plywood Corporation, on this subject, I have no objection. But to take up the matter in vacuo, I think is not helpful for the Court, and I think is irrelevant.

The Court: I will overrule the objection.

The Witness: I am glad to answer the question.

Mr. Koken: In view of the circumstance that Mr. Schweppe is a very prominent attorney in this part of the country, and has acted as counsel for both the P.F.I. and the Harbor Plywood Corporation, I did not interpose any objection to anything that he said while on the stand because of his knowledge of the situation, and I was trying to elicit from him his reasons since he wanted to approach it from a practical point of view, as to why did he not advise the P.F.I. not to issue the credit memorandum.

A. As a matter of fact, the issuance of the credit

(Testimony of Alfred J. Schweppe.)

memorandum, in and of itself, was an act of no importance. The credit was already set up on the books. The credit memorandum was merely a duplicate piece of evidence handed directly to the members telling them that they had a credit on the books as of March 31, 1943, 1944, or 1945. The issuance of the credit memorandum in and of itself does not affect the situation at all, in my opinion, except to the extent that at the time of getting the credit memoranda they were advised of the question of re-negotiability which Congress had already set up when the credit memorandum was placed on the books on March 31.

Q. (By Mr. Koken): Let me draw your attention to the credit memorandum issued as of March 31, 1944. I think we have stipulated that the Renegotiation Statute—that is, the Statute of Limitations expired on that particular one on May 11 of the following year, 1945? A. Yes.

Q. I would like to have you tell the Court why the P.F.I. did not make that payment covering the 1944 memorandum. A. In 1945?

Q. Yes.

A. I gave the answer to that a little while ago, because we didn't have the money. I pointed out the reason the 1944 memorandum was paid in 1946, in January, and the 1945 memorandum was paid in 1946, in July. The reason was that the P.F.I. didn't have the funds to pay until they actually got them. In other words, the P.F.I. had to wait until a year had run and for such additional time until they had

(Testimony of Alfred J. Schweppe.)

accumulated money to pay for the memoranda to the respective members.

Q. Don't you believe it would have been enforceable subsequent to May 11, 1945?

A. Oh, Yes. I think after the year had run the members could have enforced it.

Q. Was there any discussion on your trips to Washington with the Treasury Procurement officials about re-negotiating the petitioner Harbor Plywood Corporation at all?

A. No; they were separately re-negotiated later on by the Army Engineers at San Francisco.

Mr. Doolittle: Together with a number of other plywood companies?

The Witness: That's right.

Mr. Doolittle: Did that include any export sales?

The Witness: No. It included only the re-negotiable business that Harbor Plywood Corporation had with the respective agencies that were conducting the re-negotiation. So that as respects the plywood industry, of which there were some twenty-eight or twenty-nine companies, as a result of some conferences at Washington, the Army, the Navy, and the Air Corps jointly re-negotiated the plywood industry through the Army Engineers. There was only one re-negotiation. The Treasury Procurement dealt only with the P.F.I., but the war agencies had only one re-negotiation with the plywood company.

Q. (By Mr. Koken): Was the P.F.I. re-negotiated in any one of those years?

A. No. Actually the P.F.I. filed its papers, as

(Testimony of Alfred J. Schweppe.)

required by the Act, and we have in the record one letter in which they say, "You are subject to re-negotiation, but after looking at your figures, we are not going to re-negotiate."

Q. But they did not re-negotiate?

A. No, they did not. In later years, we didn't even get such a letter. The Statute took care of it, which provided that unless an agency took care of the matter during that year's period, the statute automatically ran.

Mr. Koken: I have no further questions.

Mr. Doolittle: I have no further question.

(Witness excused.)

Mr. Doolittle The petitioner rests.

Mr. Koken: The respondent rests.

The Court: What is your pleasure, gentlemen, with respect to briefs?

Mr. Doolittle: I would like to inquire as to practice concerning the availability of copies of the transcript. Are those available?

The Court: You will have to make your arrangements with the reporter. The petitioner will be given forty-five days for the filing of the original brief, which will be July 29, for the petitioner's original brief. Respondent's answering brief will be thirty days after, or, specifically, August 29; the reply brief will be twenty days thereafter, which will be on or before September 19th.

(Whereupon, at 11:05 o'clock a.m., June 14, 1949, hearing concluded.)

The Tax Court of the United States

Docket No. 20729

HARBOR PLYWOOD CORPORATION,
Petitioner,
vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Promulgated January 31, 1950.

FINDINGS OF FACT AND OPINION

Petitioner was a member stockholder of a cooperative nonprofit association organized as a corporation under the laws of the State of Washington (Rem. Rev. Stat., §§ 3904-3923) to engage in the export of Plywood and other forest products as authorized by the Webb Export Trade Act. During each of the taxable years 1943, 1944, and 1945, the association, pursuant to its bylaws, issued to petitioner a credit memorandum, representing petitioner's pro rata share of the excess of the association's income over its expenses for the year, and credited such amounts to petitioner in its books. In each instance, the association notified petitioner that it would not distribute the additional amounts represented by the credit memorandums until it had been settled whether it was subject to renegotiation, as the Government was contending. Both the petitioner and the association kept their books on the accrual basis. Held, that the amounts represented by the

credit memorandums accrued and are taxable to petitioner in the years when the credit memorandums were received.

WARREN A. DOOLITTLE, ESQ.,

For the petitioner.

WILLIAM E. KOKEN, ESQ.,

For the respondent.

This proceeding involves deficiencies in income and excess profits taxes as follows:

Year	Income Tax	Excess Profits Tax
1943	—	\$95,028.66
1944	—	17,407.58
1945	\$24,219.57	—

A portion of the above deficiencies are not contested in this proceeding and have been assessed by respondent since the mailing of the notice of deficiency.

The parties have filed a written stipulation which covers most of the essential facts.

Findings of Fact

The facts stipulated are found accordingly. Those facts and the additional facts shown by the evidence may be stated as follows:

Petitioner is a Delaware corporation organized in 1929, with its principal place of business located at Hoquiam, Washington. It was engaged, during the taxable years involved, in the business of manu-

facturing and distributing plywood, doors and other building materials. It kept its books and made its returns on an accrual basis and for a calendar year. Its returns were filed with the collector of internal revenue for the district of Washington.

Petitioner was one of about 25 stockholder members of a cooperative selling association, Pacific Forest Industries. That company, hereinafter referred to as Pacific, was organized as a corporation under the laws of the State of Washington solely for the purpose of exporting plywood and other forest products, as authorized under the provisions of the Webb Export Trade Act. At the close of its accounting year, and pursuant to Article XIII¹ of

¹Article XIII.

* * *

2. It is not the purpose of this Association to make a profit; and the commission charged and remuneration received by the Association shall be the cost of transacting its business as sales agent, plus the cost of developing new foreign markets.

3. If during any fiscal year the total commissions and remuneration received by this Association in such fiscal year exceeds the amount that has been incurred during said fiscal year for the payment by the Association of its expenses, including the cost of market development, then, unless the Board of Trustees by resolution shall direct otherwise, the Treasurer shall, before closing the books as of the close of said fiscal year, return or credit such excess to the accounts of the respective members and associate members, as an addition to the purchase price of the merchandise sold by them * * *.

its bylaws, it credited to its members all of its income for the year in excess of its operating expenses. Its income consisted of commissions on sales which it made on behalf of its members. It operated on the basis of a fiscal year ending March 31.

At the close of each of its fiscal years 1943, 1944, and 1945, Pacific issued to petitioner a credit memorandum representing petitioner's proportionate share of the excessive commissions which had been charged to the members on the sales of their products during the year in the respective amounts of \$11,591.36, \$33,113.41, and \$15,996.95. The face amount of each such credit memorandum was credited to the petitioner on the books of the association as of the date of its issuance and was claimed and allowed as an exclusion from gross income in the return filed by Pacific for that year.

In issuing to petitioner the credit memorandum for the year ended March 31, 1943, Pacific wrote to the petitioner in a letter dated April 24, 1943, as follows:

We are pleased to enclose Credit Memorandum to cover price adjustment on orders supplied by you and shipped by us during the period April 1st, 1942, through March 31st, 1943. The amount represents slightly more than the 6% commission deducted by us when settling your invoices. This means that P.F.I. business during the past fiscal year was handled at no expense to you and we hope to be able to continue on this basis.

May we point out, however, that the Treasury Department has filed with us a request for renegotiation of the contracts which we have accepted and are filling. It is, therefore, impossible to distribute the additional price evidenced by the enclosed Credit Memorandum until the results of the renegotiation are known. We believe, however, that the results will be favorable since, in the first place, we are a non-profit organization and secondly, all plywood which we have shipped has gone outside the Continental United States and thus the contracts should not be subject to renegotiation under the law.

Each of the other credit memorandums for the fiscal years 1944 and 1945 was issued subject to the same restriction as to payment. Petitioner at all times maintained that it was not subject to renegotiation and was finally sustained in that contention.

The renegotiation of Pacific for its fiscal years ended 1943, 1944, and 1945 was barred by the running of the statute of limitations on the dates of March 31, 1944, May 11, 1945, and May 29, 1946, respectively.

Pacific paid the credit memorandums issued to petitioner for 1943, 1944 and 1945 in cash on the dates of December 12, 1944, January 29, 1946, and July 23, 1946, respectively. The delay of these payments beyond the dates of expiration of the statute of limitations on renegotiation was due to the fact that Pacific had not collected for all of its sales and

did not have sufficient cash on hand to make the payments sooner.

Petitioner reported the income represented by the credit memorandums in the years when it received the cash payments on them. The respondent determined that the amounts accrued and were taxable to petitioner when the credit memorandums were received. Both parties make the alternative contention that the running of the statute of limitations on renegotiation of petitioner determined the time of the accrual and the time for reporting each of the credit memorandums.

Opinion

LeMire, Judge:

Our sole question here is whether the amounts represented by the credit memorandums issued by Pacific are taxable to petitioner in the years when it received them, as contended by the respondent, or in the years when they were paid by Pacific, as petitioner contends; or, as both parties contend in the alternative, in the years when renegotiation of Pacific became barred by the statute of limitations.

A taxpayer keeping its books and making its returns on an accrual basis must report income when the right to receive it becomes fixed. *Spring City Foundry Co. v. Commissioner*, 292 U. S. 182. In *Liebes & Co. v. Commissioner*, 90 Fed. (2d) 932, the court said, after a thorough review of the leading cases dealing with the different aspects of the accrual question:

The complete definition would therefore seem to be that income accrues to a taxpayer, when there arises to him a fixed or unconditional right to receive it, if there is a reasonable expectancy that the right will be converted into money or its equivalent.

If there is any contingency as to the taxpayer's right to the income, as distinguished from an uncertainty as to the time of its receipt, it is taxable in the year when the contingency is removed. *United States v. Safety Car Heating & Lighting Co.*, 297 U. S. 88. Here the income in dispute had already been earned and had been credited to the petitioner on the books of Pacific when the credit memorandums were issued. There was no contingency as to the amount of income represented by the credit memorandums or of Pacific's right to receive it; nor was there any contingency as to petitioner's right to whatever income might remain after renegotiation, should that occur. The mere possibility of renegotiation did not give rise to a liability which either Pacific or the petitioner could have accrued on its books, since it had not become fixed and was being strenuously protested by Pacific. No liability for renegotiation was set up in Pacific's books. Conceding that there was a possibility of renegotiation there was no way of even approximating the amount of excessive profits that might be claimed by the Government. See *Security Flour Mills Co. v. Commissioner*, 321 U. S. 281; *William Justin Petit*, 8 T. C. 228.

There can be no question but that Pacific, keeping its books on an accrual basis, was required to account for the entire amount of the commissions on sales made during the taxable years. It is now well settled, however, that cooperative associations, such as Pacific, engaged exclusively in selling the products of its stockholder members on a commission basis are not taxable on the income which, pursuant to their articles of incorporation or bylaws, or contracts, they are required to return to the stockholders each year as patronage dividends or rebates. See *San Joaquin Valley Poultry Producers' Assn.*, 136 Fed. (2d) 382; *Midland Cooperative Wholesale*, 44 B.T.A. 824; *United Cooperatives, Inc.*, 4 T. C. 93. This is true whether the amounts are actually paid to the members in cash during the taxable year or merely credited to them on the books of the association. *Midland Cooperative Wholesale*, *supra*. The reason for this rule is that the patronage dividends or rebates are at all times the property of the member stockholders, and nonmembers, and that the selling association is an agent or trustee or mere conduit for the income.

The petitioner devotes a substantial portion of its opening brief to the argument that it did not constructively receive the amounts represented by the credit memorandums in the years when they were issued. The question of constructive receipt is not involved. It might have been had the petitioner reported on a cash basis rather than an accrual basis. The Commissioner has not determined and

does not now argue that petitioner constructively received any of the disputed income. Cases like *Kay Kimbell*, 41 B.T.A. 940, and *Howard Veit*, 8 T. C. 809, which petitioner cites, have no application here.

We think that the respondent has correctly determined that the amounts represented by the credit memorandums issued to petitioner in each of the taxable years accrued and are taxable to petitioner in those years.

Reviewed by the Court.

Decision will be entered under Rule 50.

Disney, J., dissenting:

The majority opinion recognizes that a taxpayer on the accrual basis is to report income when the right to receive it becomes fixed. At the time that the petitioner was informed, by the cooperative corporation, that a credit memorandum was being enclosed for the year, the petitioner was also informed that the Treasury Department had requested renegotiation and the distribution could not be made until the results of renegotiation were known. It seems to me this is a case where the right to receive income had not become fixed but that there was a very great contingency. Until that contingency was removed I do not think that item was accrued. The majority opinion appears to treat the renegotiation as not of sufficient importance to constitute a contingency. It is referred to as "the mere possibility of renegotiation." Obviously it was a probability

for the Treasury Department had asked for it. The result of renegotiation was altogether problematical and contingent. In my opinion, the taxpayer upon the accrual basis should not be required to accrue such an uncertain and contingent item. I, therefore, dissent.

Served February 1, 1950.

[Title of Tax Court and Cause.]

COMPUTATION BY PARTIES FOR ENTRY OF DECISION

The attached proposed computation is submitted on behalf of the parties to the Tax Court of the United States in compliance with its opinion determining the issues in this proceeding.

This computation is submitted in accordance with the opinion of the Tax Court, without prejudice to the parties' rights to contest the correctness of the decision entered herein by the Tax Court, pursuant to the statutes in such cases made and provided.

/s/ WARREN A. DOOLITTLE,
Counsel for the Petitioner.

/s/ CHARLES OLIPHANT, W.H.R.
Chief Counsel, Bureau of Internal Revenue, Coun-
sel for the Respondent.

C-TS:NWD:RECOMP
S:WEK:WMG

Recomputation Statement

Petitioner: Harbor Plywood Corporation
Box 300
Hoquiam, Washington

Docket No.: 20729

Tax Liability for the Taxable Years Ended December 31, 1943,
December 31, 1944, and December 31, 1945

Claims for refund Nos.: 3407808 and 000663 filed for 1943
and 000661 and 000662 filed for 1944

Income Tax				Over-
Year	Liability	Assessed	Deficiency	assessment
1943.....	\$129,776.21	\$162,395.08		\$32,618.87
1944.....	118,369.30	120,690.55		2,321.25
1945.....	90,078.97	65,859.40	\$ 24,219.57	
<hr/>				<hr/>
Total.....	\$338,224.48	\$348,945.03	\$ 24,219.57	\$34,940.12

Excess Profits Tax			
1943.....	\$225,388.25	\$130,359.59	\$ 95,028.66
1944.....	136,200.54	118,792.96	17,407.58
<hr/>			
Total.....	\$361,588.79	\$249,152.55	\$112,436.24

Note: Payment of \$28,825.89 on September 29, 1948, covering net deficiencies for 1943, 1944 and 1945 resulting from unproved adjustments, has not been assessed and is being held in Collector's unidentified Account No. 1-500078-50, also the unapplied balance of \$10,608.96 of a payment made on December 27, 1945 is being held in Collector's unidentified Account No. 1-500030-47.

Recomputation of tax liability prepared in accordance with the memorandum opinion of The Tax Court of the United States promulgated January 31, 1950.

Taxable Year Ended December 31, 1943

Schedule 1
Tax Liability

Income Tax

Liability disclosed by statutory notice of deficiency dated July 23, 1948	\$129,776.21		
Previously assessed, Account No. 7-410043.....	\$107,032.83		
Additional, Section 3780(b), July 16, 1946..	55,362.25	162,395.08	
Over-assessment of income tax		\$ 32,618.87	

Excess Profits Tax

Liability disclosed by statutory notice of deficiency dated July 23, 1948	\$225,388.25		
Previously assessed, Account No. 7-400054	\$248,705.68		
Less: Tentative allowance, Schedule No. A.M. 375	\$ 6,237.54		
Tentative allowance, Schedule No. I:T:CB:868	112,108.55	118,346.09	130,359.59
Deficiency in excess profits tax		\$ 95,028.66	

Taxable Year Ended December 31, 1944

Schedule 2
Tax Liability

Income Tax

Liability disclosed by statutory notice of deficiency dated July 23, 1948	\$118,369.30		
Previously assessed, Account No. 5-410148	120,690.55		
Over-assessment of income tax		\$ 2,321.25	

Excess Profits Tax

Liability disclosed by statutory notice of deficiency dated July 23, 1948	\$136,200.54		
Previously assessed, Account No. 5-400104	\$172,175.20		
Less: Section 784(a) credit allowed	\$17,217.52		
Section 3806(b)(1) credit allowed	23,939.99		
Tentative allowance, Schedule No. A.M. 375	12,224.73	53,382.24	118,792.96
Deficiency in excess profits tax		\$ 17,407.58	

Taxable Year Ended December 31, 1945

Schedule 3
Tax Liability

Income Tax

Liability disclosed by the statutory notice of deficiency dated July 23, 1948	\$90,078.97
Previously assessed, Account No. 6-410075	65,859.40
Deficiency in income tax	<u>\$24,219.57</u>

Note: Payment of \$28,825.89 on September 29, 1948, covering net deficiencies for 1943, 1944 and 1945 resulting from unprotested adjustments, has not been assessed and is being held in Collector's unidentified Account No. 1-500078-50, also the unapplied balance of \$10,608.96 of a payment made on December 27, 1945, is being held in Collector's unidentified Account No. 1-500030-47.

C-TS:NWD
S:WEK:WMG

Statement of Account

Petitioner: Harbor Plywood Corporation
Box 300
Hoquiam, Washington

Docket No. : 20729

Taxable Years Ended December 31, 1943, 1944 and 1945

1943

Income tax liability			\$129,776.21
Income tax assessed, Account No. 7-410043	\$107,032.83		
Additional, 7-Spl #6-04C-46	55,362.25	162,395.08	
Over-assessment of income tax to be abated		\$ 32,618.87	
Income tax liability		\$129,776.21	
Income tax paid:			
March 10, 1944	\$ 6,214.21		
June 30, 1944	26,758.21		
March 10, 1944	20,544.00		
September 14, 1944	26,758.20		
December 14, 1944	26,758.21		
Credit	55,362.25*	162,395.08	
Overpayment of income tax		\$ 32,618.87	
Excess profits tax liability		\$225,388.25	
Excess profits tax assessed,			
Account No. 7-400054	\$248,705.68		
Less: Tentative allowance			
Schedule No. AM-375	\$ 6,237.54		
Tentative allowance,			
Schedule No. IT:CB-868	112,108.55	118,346.09	130,359.59
Deficiency in assessment		\$ 95,028.66	
Excess profits tax liability		\$225,388.25	
Less: Excess profits tax paid:			
June 30, 1944	\$ 73,741.79		
March 10, 1944	69,027.79		
September 14, 1944	43,759.68		
December 14, 1944	62,176.42	\$248,705.68	
Less: Amount applied against excess			
profits tax for 1944	\$ 6,237.54**		
Amount refunded	56,746.30		
Amount applied against add'l.			
income tax for 1943	55,362.25*	118,346.09	130,359.59
Deficiency in payment		\$ 95,028.66	

1944

Income tax liability	\$118,369.30
Income tax assessed, Account No. 5-410148	120,690.55

Over-assessment of income tax to be abated	\$ 2,321.25
Income tax liability	\$118,369.30

Income tax paid:

May 15, 1945	\$ 27,250.00	
March 15, 1945	2,923.00	
June 15, 1945	30,172.28	
September 6, 1945	30,172.63	
December 14, 1945	30,172.64	120,690.55

Overpayment of income tax	\$ 2,321.25
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Excess profits tax liability	\$136,200.54
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Excess profits tax assessed,

Account No. 5-400104	\$172,175.20
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Less: Abatement, Schedule

No. AM-375	\$ 12,224.73
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Abatement, Schedule

No. 194	17,217.52
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Section 3806(b)(1) credit..	23,939.99	53,382.24	118,792.96
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Deficiency in assessment	\$ 17,407.58
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Excess profits tax liability	\$136,200.54
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Excess profits tax paid:

March 15, 1945	\$ 59,827.00	
June 15, 1945	26,260.60	
September 6, 1945	34,435.04	
December 14, 1945	15,972.77	
Credit	**6,237.54	\$142,732.95

Less: Credit under Section 3806(b)(1)	23,939.99	118,792.96
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Deficiency in payment	\$ 17,407.58
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1945

Income tax liability	\$ 90,078.97
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Income tax assessed, Account No. 6-410075	65,859.40
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Deficiency in assessment	\$ 24,219.57
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Income tax liability	\$ 90,078.97
----------------------------	--------------

Income tax paid:

June 14, 1946	\$ 2,929.70	
March 14, 1946	30,000.00	
September 6, 1946	16,464.85	
January 2, 1947	16,464.85	65,859.40

Deficiency in payment	\$ 24,219.57
-----------------------------	--------------

Statutory notice of deficiency dated July 23, 1948.

Claims for refund filed:

3407808 and 000663 for 1943

000661 and 000662 for 1944

Received and Filed T. C. U. S. April 21, 1950.

The Tax Court of the United States
Washington

Docket No. 20729

HARBOR PLYWOOD CORPORATION,
Petitioner,
vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DECISION

Pursuant to the Court's Opinion, promulgated January 31, 1950, the parties filed an agreed computation. Therefore, it is

Decided that there are deficiencies in excess profits tax of \$95,028.66 and \$17,407.58 for 1943 and 1944, respectively; that there is a deficiency of \$24,219.57 in income tax for 1945.

[Seal] /s/ C. P. LEMIRE,
Judge.

Entered Apr. 25, 1950.

Served Apr. 27, 1950.

United States Circuit Court of Appeals
for the Ninth Circuit

Docket No. 20729

HARBOR PLYWOOD CORPORATION,
Appellant,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Appellee.

PETITION FOR REVIEW OF THE DECISION
OF THE TAX COURT OF THE UNITED
STATES

To the Honorable the Judges of the United States
Circuit Court of Appeals for the Ninth Circuit:

Harbor Plywood Corporation, the appellant in this case (petitioner below), by Warren A. Doolittle, its attorney, hereby files its petition for review by the United States Circuit Court of Appeals for the Ninth Circuit of the decision of the Tax Court of the United States entered herein on April 25, 1950, which decision approved the deficiencies determined by the Commissioner of Internal Revenue in excess profits taxes of \$95,028.66 and \$17,407.58 for 1943 and 1944, respectively, and a deficiency of \$24,219.57 in income tax for 1945.

In support of this petition for review, filed in pursuance of the provisions of Sections 1141 and 1142 of the Internal Revenue Code, for a review of such decision, your petitioner respectfully shows to this honorable court, as follows:

I. Statement of the Nature of the Controversy

This case presents the very simple question as to the proper time for the reporting of income by the petitioner, Harbor Plywood Corporation, an accrual basis taxpayer. The income in question consists of three separate refunds received by the taxpayer from Pacific Forest Industries, a corporation engaged solely in the export of plywood and other forest products for its member stockholders. The taxpayer at all times material was a member stockholder in Pacific Forest Industries. The taxpayer was and is in the business of manufacturing and distributing plywood, doors and building material. It makes no sales in the export trade of its plywood or other forest products; instead its exports are marketed through Pacific Forest Industries, the latter being a corporation authorized by the Webb Export Trade Act. During each of the taxable years, 1943, 1944 and 1945, Pacific Forest Industries, pursuant to its by-laws, issued to the taxpayer a credit memorandum, representing the taxpayer's pro-rata share of the excess of Pacific Forest Industries income over its expenses for the year, and the amounts of each credit memorandum were credited to the taxpayer on the books of account of Pacific Forest Industries. Similar credit memoranda were issued to the other 18 companies who were stockholder members. At all times involved in this case Pacific Forest Industries was threatened in writing with the actual renegotiation of its profits by the Treasury Department Procure-

ment Division handling lend-lease contracts as provided by the Renegotiation Act of 1942. Because of this threat each credit memorandum issued to the taxpayer and the other members for each year was issued subject to the possible renegotiation of Pacific Forest Industries; that is to say, the Pacific Forest Industries notified the taxpayer and the other stockholder members as the credit memoranda were issued for each year, that it would not distribute the additional amounts represented by the credit memoranda until it had been settled whether or not Pacific Forest Industries was subject to renegotiation as the Government was contending.

The renegotiation of Pacific Forest Industries for its fiscal years ended 1943, 1944 and 1945, was barred by the running of the statute of limitations on the dates of March 31, 1944, May 11, 1945, May 29, 1946, respectively. Pacific Forest Industries paid the credit memoranda issued to the taxpayer for 1943, 1944, and 1945 in cash on the dates of December 12, 1944, January 29, 1946, and July 23, 1946, respectively. The delay of these payments beyond the dates of expiration of the statute of limitations on renegotiation for each year was due to the fact that Pacific Forest Industries had not collected for all of its sales (all of which were made to the Government for Lend-Lease) and did not have sufficient cash on hand to make the payments sooner.

The taxpayer reported the income represented by the credit memoranda in the years when it received the cash payments on them. The Commissioner of Internal Revenue determined that the

amounts should have been accrued as income and were taxable to the taxpayer when each credit memorandum was received. Both parties in the Tax Court made the alternative contention that the running of the statute of limitations on renegotiation of Pacific Forest Industries determined the time of accrual and the time for reporting as taxable income each of the credit memoranda by the taxpayer, Harbor Plywood Corporation.

The Tax Court held, and the taxpayer disagrees with the holding, that the amounts represented by the credit memoranda accrued and were taxable to the taxpayer, Harbor Plywood Corporation, in the years when the credit memoranda were issued, notwithstanding that the Tax Court also found that they were issued expressly "subject to Renegotiation."

The controversy before this Court involves the following questions:

1. Was the Tax Court correct in holding that the amounts represented by the credit memoranda which were expressly issued "subject to Renegotiation," constituted a part of the taxable income of the taxpayer, Harbor Plywood Corporation, and should have been accrued in the taxable year in which each credit memorandum was issued by Pacific Forest Industries? or

2. Should the amounts represented by each credit memorandum have been accrued and have been taxable to Harbor Plywood Corporation for the year during which the statute of limitations expired on the renegotiability of Pacific Forest Indus-

tries, as contended in the alternative by both parties?
or

3. Should the amounts of the credit memoranda have been reported as income for the year in which each credit memorandum was paid in cash to the taxpayer by Pacific Forest Industries?

II. Designation of Court of Review and Allegations as to Venue

The appellant is a corporation duly organized and existing under the laws of the State of Delaware, and has its principal place of business at Hoquiam, Washington.

The appellant filed its income and excess profits tax returns for the years in question, namely, the taxable calendar years, 1943, 1944 and 1945, with the Collector of Internal Revenue for the Washington District, which office is situated in the City of Tacoma, State of Washington, and is located within the jurisdiction of the United States Circuit Court of Appeals for the Ninth Circuit where this review is sought pursuant to the provisions of Internal Revenue Code, Sections 1141 and 1142.

III. Assignments of Errors

The appellant assigns as errors the following acts and omissions of the Tax Court of the United States:

1. The conclusion of the Tax Court of the United States that the amounts represented by the credit memoranda issued to the taxpayer, Harbor Ply-

wood Corporation, in each of the taxable years by Pacific Forest Industries accrued and were taxable to the taxpayer in the year of their issuance, notwithstanding that they were issued, as the Tax Court properly found, "subject to renegotiation" for all years.

2. The holding of the Tax Court of the United States that when the credit memoranda were issued subject to renegotiation there was no contingency as to the amount of income represented by the credit memoranda or of Harbor's right to receive it.

3. The opinion of the Tax Court that the threat of renegotiation was a "mere possibility of renegotiation," as being contrary to the evidence.

4. The opinion of the Tax Court that the "mere possibility" of the renegotiation of Pacific Forest Industries under the Renegotiation Act of 1942 had no effect upon Harbor Plywood Corporation's duty to accrue the income represented by the credit memoranda which were issued with notice that they were issued subject to renegotiation.

5. The opinion of the Tax Court that the method of accounting and the time for deducting expenses by Pacific Forest Industries is in any way determinative of the method of accruing and the time for reporting income by the taxpayer, Harbor Plywood Corporation.

6. The reliance of the Tax Court on the cases dealing with patronage dividends by cooperatives, none of which were concerned with a threatened

or an actual renegotiation of a cooperative's income under the Renegotiation Act of 1942.

7. The failure of the Tax Court of the United States to recognize that, notwithstanding that the taxpayer is an accrual basis taxpayer, certain of the concepts and cases decided under the principal of "constructive receipt" of income by cash basis taxpayers are relevant and persuasive by way of analogy.

8. The making and entry by the Tax Court of the United States of its decision of April 25, 1950.

9. The failure of the Tax Court to find that these credits from Pacific Forest Industries were not taxable income to taxpayer, Harbor Plywood Corporation, until paid in cash; or, in the alternative, the failure of the Tax Court to find, under the true rule of "accrued income," that when the credit memoranda were issued, the taxpayer had no fixed and unconditional right to the amount of each memorandum because at such time

(a) there was a contingency which might preclude ultimate payment, namely, the possible Renegotiation of Pacific Forest Industries;

(b) no reasonable expectancy that the right would be converted into money could exist so long as such unresolved and intervening legal right as was created by the Renegotiation Act itself was not barred by the statute of limitations; and

(c) there was the further contingency which

precluded payment imposed by Pacific Forest Industries itself, namely, the fact that it notified the taxpayer in writing that each credit memorandum was issued "subject to renegotiation,"

and therefore the amounts represented by said credit memoranda could not be accrued as taxable income by the taxpayer, Harbor Plywood Corporation, until the statute of limitations barred the Renegotiation of Pacific Forest Industries' income.

The appellant herein being aggrieved by the said decision of the Tax Court of the United States and by the said errors and omissions heretofore referred to, desires to obtain a review of the said decision, and of all the proceedings heretofore had before the Tax Court of the United States, by the United States Circuit Court of Appeals for the Ninth Circuit, to the end that the errors and omissions of the Tax Court of the United States be corrected and that the Tax Court of the United States be directed to enter an order in the above-entitled cause of either (1) "No deficiency"; or, in the alternative, (2) that the amounts represented by the credit memoranda issued by Pacific Forest Industries to Harbor Plywood Corporation were taxable to Harbor Plywood Corporation and should have been accrued by it in the years when the statute of limitations barred the renegotiation of Pacific Forest Industries, and not before.

/s/ WARREN A. DOOLITTLE,
Attorney for Appellant.

Received and filed T.C.U.S. July 17, 1950.

[Title of Court of Appeals and Cause.]

NOTICE OF FILING PETITION
FOR REVIEW

To Chief Counsel, Bureau of Internal Revenue,
Washington, D. C.:

Please Take Notice that the appellant, Harbor Plywood Corporation, by Warren A. Doolittle, its attorney, on the 15th day of July, 1950, is mailing to the Clerk of the Tax Court of the United States at Washington, D. C., for filing, a Petition for Review by the United States Circuit Court of Appeals for the Ninth Circuit, of the decision of the Tax Court heretofore entered on April 25, 1950, in the above-entitled cause.

A copy of the petition for review and the assignments of error as will be filed is hereto attached and served upon you.

Dated this 15th day of July, 1950.

/s/ WARREN A. DOOLITTLE,
Attorney for Appellant.

Personal service of the foregoing Notice, together with a copy of the petition for review and assignments of error mentioned therein is hereby acknowledged this 17th day of July, 1950.

/s/ CHARLES OLIPHANT, CAR
Chief Counsel, Bureau of Internal Revenue, Counsel
for Appellee.

Received and filed T.C.U.S. July 26, 1950.

[Title of Court of Appeals and Cause.]

NOTICE OF FILING PETITION
FOR REVIEW

To: Charles Oliphant, Chief Counsel, Bureau of
Internal Revenue:

You are hereby notified that Harbor Plywood Corporation did, on the 17th day of July, 1950, file with the Clerk of The Tax Court of the United States, at Washington, D. C., a petition for review by the United States Court of Appeals for the Ninth Circuit, of the decision of this Court heretofore rendered in the above-entitled case. Copy of the petition for review as filed is hereto attached and served upon you.

Dated this 19th day of July, 1950.

/s/ VICTOR S. MERSCH,
Clerk The Tax Court
Of the United States.

Service of copy of Petition for Review acknowledged this 19th day of July, 1950.

/s/ CHARLES OLIPHANT, CAR
Chief Counsel, Bureau of Internal Revenue, Attorney for Respondent.

Filed T.C.U.S. July 19, 1950.

[Title of Court of Appeals and Cause.]

PRAECIPE FOR RECORD

To the Clerk of The Tax Court of the United States:

You are hereby requested to prepare and certify and transmit to the Clerk of the United States Circuit Court of Appeals for the Ninth Circuit, with reference to the Petition for Review heretofore filed by the Appellant in the above-entitled cause, a transcript of the record in the above-entitled cause prepared and transmitted as required by law and by the rules of said Court, and to include in said transcript the following documents or certified copies thereof:

1. Docket entries of all proceedings in the above-entitled cause before The Tax Court of the United States.

2. Pleadings before The Tax Court of the United States as follows:

(a) Petition filed in this cause on October 20, 1948.

(b) Respondent's Answer.

(c) Motion to Amend Petition, filed June 13, 1949.

(d) Amendment to Petition, verified May 27, 1949, and filed at hearing on June 13, 1949.

(e) Answer to Amendments to Petition and Amendment to Respondent's Answer.

3. Stipulation of Facts, including all exhibits

(joint exhibits 1-A to 15-O, inclusive) attached thereto.

4. Transcript of the proceedings, and evidence adduced at The Tax Court hearing held in room 304, United States Courthouse, Tacoma, Washington, June 14, 1949, including, but not limited to, joint exhibits 16-P to 22-V admitted in evidence at said hearing.

5. Findings of Fact and Opinion by The Tax Court of the United States, promulgated January 31, 1950, including the dissenting Opinion attached thereto.

6. Computation by parties for entry of decision.

7. Decision of The Tax Court of the United States entered April 25, 1950.

8. Petition for Review of the Decision of The Tax Court of the United States, filed by the Appellant in the above-entitled cause, and Notice of Filing Petition for Review with acknowledgment of service.

9. This Praecipe for Record.

/s/ WARREN A. DOOLITTLE,
Attorney for Appellant.

Personal service of a copy of the foregoing Praecipe is hereby acknowledged, this 31st day of July, 1950.

/s/ CHARLES OLIPHANT, CAR
Chief Counsel, Bureau of Internal Revenue, Counsel
for Appellee.

Received and filed T.C.U.S. August 7, 1950.

[Title of Tax Court and Cause.]

CERTIFICATE

I, Victor S. Mersch, Clerk of The Tax Court of the United States do hereby certify that the foregoing documents, 1 to 14, inclusive, constitute and are all of the original papers and proceedings on file in my office, including Exhibits 1-A through 15-O, Attached to Stipulation of Facts and Exhibits 16-P through 22-V Admitted in Evidence, as called for by the Praecipe for Record on Review in the proceeding before The Tax Court of the United States entitled: "Harbor Plywood Corporation v. Commissioner of Internal Revenue, Respondent," Docket No. 20729 and in which the petitioner in The Tax Court proceeding has initiated an appeal as above numbered and entitled, together with a true copy of the docket entries in said Tax Court proceeding, as the same appear in the official docket book in my office.

In testimony whereof, I hereunto set my hand and affix the seal of The Tax Court of the United States, at Washington, in the District of Columbia, this 10th day of August, 1950.

[Seal] /s/ VICTOR S. MERSCH,
Clerk, Tax Court of the
United States.

[Endorsed]: No. 12660. United States Circuit Court of Appeals for the Ninth Circuit. Harbor Plywood Corporation, a Corporation, Petitioner, vs. Commissioner of Internal Revenue, Respondent. Transcript of the Record. Upon Petition to Review a Decision of The Tax Court of the United States.

Filed August 21, 1950.

/s/ PAUL P. O'BRIEN,

Clerk of the United States Circuit Court of Appeals for the Ninth Circuit.

United States Circuit Court of Appeals
for the Ninth Circuit

Case No. 12660

HARBOR PLYWOOD CORPORATION,
Appellant,
vs.

COMMISSIONER OF INTERNAL REVENUE,
Appellee.

STATEMENT OF POINTS AND DESIGNA-
TION OF RECORD TO BE PRINTED

Comes now the Petitioner on Review herein and adopts as his Statement of Points on which he intends to rely on the Review herein the Assignments of Errors included in his Petition for Review within the Transcript of Record, and he also designates for printing the entire Transcript of Record

(specifically excepting from Document No. 9 thereof, however, Exhibits 20-T, 21-U and 22-V) transmitted to this Court by the Clerk of The Tax Court of the United States, together with this Statement and Designation.

/s/ WARREN A. DOOLITTLE,
Attorney for Appellant.

Personal service of the foregoing Statement of Points and Designation of Record to be Printed is hereby acknowledged this 30th day of August, 1950.

/s/ THERON LAMAR CAUDLE,
Ass't Att'y General,
Counsel for Respondent.

[Endorsed]: Filed September 11, 1950.

No. 12660

In The United States Court of Appeals
For the Ninth Circuit

HARBOR PLYWOOD CORPORATION,
a Corporation, *Petitioner,*

VS

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

UPON PETITION TO REVIEW A DECISION OF
THE TAX COURT OF THE
UNITED STATES

PETITIONER'S BRIEF

WARREN A. DOOLITTLE,
Attorney for Petitioner.

657-671 Colman Building,
Seattle 4, Washington.

THE ARDUS PRESS, SEATTLE

FILED

DEC - 4 1950

PAUL P. O'BRIEN

No. 12660

In The United States Court of Appeals
For the Ninth Circuit

HARBOR PLYWOOD CORPORATION,
a Corporation, *Petitioner,*

VS

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

UPON PETITION TO REVIEW A DECISION OF
THE TAX COURT OF THE
UNITED STATES

PETITIONER'S BRIEF

WARREN A. DOOLITTLE,
Attorney for Petitioner.

657-671 Colman Building,
Seattle 4, Washington.

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(a) there was a contingency which might preclude ultimate payment, namely, the possible and probable renegotiation of Pacific Forest Industries;	
(b) No reasonable expectancy that the right would be converted into money could exist so long as such unresolved and intervening legal right as was created by the Renegotiation Act itself was not barred by the statute of limitations; and	

(c) There was a further contingency which precluded payment imposed by Pacific Forest Industries itself, namely, the fact that it notified the taxpayer in writing, as The Tax Court properly found for each year, that each credit memorandum was issued "subject to Renegotiation";

and therefore, the amounts represented by said credit memoranda could not be accrued as taxable income by the taxpayer, Harbor Plywood Corporation, until the statute of limitations barred the Renegotiation of Pacific Forest Industries' income (Assignment of Error IX).....45-46

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In The United States Court of Appeals
For the Ninth Circuit

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UPON PETITION TO REVIEW A DECISION OF
THE TAX COURT OF THE
UNITED STATES

PETITIONER'S BRIEF

OPINION BELOW

The previous opinion and dissenting opinion in this case is the opinion of The Tax Court of the United States, 14 T.C. No. 20, Docket No. 20729, promulgated January 31, 1950 (R. 124-133).

JURISDICTION

This is a proceeding to review a decision of The Tax Court of the United States entered herein on April 25, 1950, which decision approved the deficiencies determined by the Commissioner of Internal Revenue in excess profits taxes of \$95,028.66 and \$17,407.58 for 1943 and 1944, respectively, and a deficiency of \$24,219.57 in income tax for 1945 (R. 139).

From respondent's determination of proposed deficiencies for each of said years a petition was filed with

The Tax Court of the United States (R. 4-11), which petition, pursuant to leave of said Tax Court, was amended by the service and filing of an amendment to said petition (R. 19-22). Said case was heard before the Honorable C. P. Le Mire, Judge of The Tax Court, on June 14, 1949, and the findings of fact and opinion in the cause were promulgated on January 31, 1950 (R. 124-133). The agreed computation by the parties for entry of decision was filed April 21, 1950, and the decision of The Tax Court thereon was entered on April 25, 1950.

The petitioner is a corporation duly organized and existing under the laws of the State of Delaware, and has its principal place of business at Hoquiam, Washington.

The petitioner filed its income and excess profits tax returns for the years in question, namely, the taxable calendar years 1943, 1944 and 1945, with the Collector of Internal Revenue for the Washington District, which office is situated in the City of Tacoma, State of Washington, and is located within the jurisdiction of the United States Court of Appeals for the Ninth Circuit where this review is sought pursuant to the provisions of Internal Revenue Code, Sections 1141 and 1142 (R. 144).

This appeal was taken by Petition For Review filed July 17, 1950 (R. 147) and notice of such filing served on respondent on July 17, 1950 and filed July 26, 1950 (R. 148).

This Court has jurisdiction under Sections 1141 and 1142 of the Internal Revenue Code.

STATEMENT OF THE CASE
and
QUESTIONS INVOLVED

This case presents the very simple question as to the proper time for the reporting of income by the petitioner, Harbor Plywood Corporation, an accrual basis taxpayer. The income in question consists of three separate refunds received by the taxpayer from Pacific Forest Industries, a corporation engaged solely in the export of plywood and other forest products for its member stockholders. The taxpayer at all times material was a member stockholder in Pacific Forest Industries. The taxpayer was and is in the business of manufacturing and distributing plywood, doors and building material. It makes no sales in the export trade of its plywood or other forest products; instead its exports are marketed through Pacific Forest Industries, the latter being a corporation authorized by the Webb Export Trade Act. During each of the taxable years, 1943, 1944 and 1945, Pacific Forest Industries, pursuant to its by-laws, issued to the taxpayer a credit memorandum, representing the taxpayer's pro-rata share of the excess of Pacific Forest Industries income over its expenses for the year, and the amounts of each credit memorandum were credited to the taxpayer on the books of account of Pacific Forest Industries. Similar credit memorandum were issued to the other 18 companies who were stockholder members. At all times involved in this case Pacific Forest Industries was threatened in writing with the actual renegotiation of its profits by the Treasury Department Procure-

ment Division handling lend-lease contracts as provided by the Renegotiation Act of 1942. Because of this threat each credit memorandum issued to the taxpayer and the other members for each year was issued subject to the possible renegotiation of Pacific Forest Industries; that is to say, the Pacific Forest Industries notified the taxpayer and the other stockholder members as the credit memoranda were issued for each year, that it would not distribute the additional amounts represented by the credit memoranda until it had been settled whether or not Pacific Forest Industries was subject to renegotiation as the Government was contending.

The renegotiation of Pacific Forest Industries for its fiscal years ended 1943, 1944 and 1945, was barred by the running of the statute of limitations on the dates of March 31, 1944, May 11, 1945, May 29, 1946, respectively. Pacific Forest Industries paid the credit memoranda issued to the taxpayer for 1943, 1944, and 1945 in cash on the dates of December 12, 1944, January 29, 1946, and July 23, 1946, respectively. The delay of these payments beyond the dates of expiration of the statute of limitations on renegotiation for each year was due to the fact that Pacific Forest Industries had not collected for all of its sales (all of which were made to the Government for Lend-Lease) and did not have sufficient cash on hand to make the payments sooner.

The taxpayer reported the income represented by the credit memoranda in the years when it received the cash payments on them. The Commissioner of Internal Revenue determined that the amounts should

have been accrued as income and were taxable to the taxpayer when each credit memorandum was received. Both parties in the Tax Court made the alternative contention that the running of the statute of limitations on renegotiation of Pacific Forest Industries determined the time of accrual and the time for reporting as taxable income each of the credit memoranda by the taxpayer, Harbor Plywood Corporation.

The Tax Court held, and the taxpayer disagrees with the holding, that the amounts represented by the credit memoranda accrued and were taxable to the taxpayer, Harbor Plywood Corporation, in the years when the credit memoranda were issued, notwithstanding that the Tax Court also found that they were issued expressly "subject to Renegotiation."

The controversy before this Court involves the following questions:

1. Was the Tax Court correct in holding that the amounts represented by the credit memoranda which were expressly issued "subject to Renegotiation," constituted a part of the taxable income of the taxpayer, Harbor Plywood Corporation, and should have been accrued in the taxable year in which each credit memorandum was issued by Pacific Forest Industries? or

2. Should the amounts represented by each credit memorandum have been accrued and have been taxable to Harbor Plywood Corporation for the year during which the statute of limitations expired on the renegotiability of Pacific Forest Industries, as contended in the alternative by both parties? or

3. Should the amounts of the credit memoranda have been reported as income for the year in which each credit memorandum was paid in cash to the taxpayer by Pacific Forest Industries?

ASSIGNMENTS OF ERRORS

The petitioner assigns as errors the following acts and omissions of The Tax Court of the United States:

1. The conclusion of the Tax Court of the United States that the amounts represented by the credit memoranda issued to the taxpayer, Harbor Plywood Corporation, in each of the taxable years by Pacific Forest Industries accrued and were taxable to the taxpayer in the year of their issuance, notwithstanding that they were issued, as the Tax Court properly found, "subject to renegotiation" for all years.

2. The holding of the Tax Court of the United States that when the credit memoranda were issued subject to renegotiation there was no contingency as to the amount of income represented by the credit memoranda or of Harbor's right to receive it.

3. The opinion of the Tax Court that the threat of renegotiation was a "mere possibility of renegotiation," as being contrary to the evidence.

4. The opinion of the Tax Court that the "mere possibility" of the renegotiation of Pacific Forest Industries under the Renegotiation Act of 1942 had no effect upon Harbor Plywood Corporation's duty to accrue the income represented by the credit memoranda which were issued with notice that they were issued subject to renegotiation.

5. The opinion of the Tax Court that the method of accounting and the time for deducting expenses by Pacific Forest Industries is in any way determinative of the method of accruing and the time for reporting income by the taxpayer, Harbor Plywood Corporation.

6. The reliance of the Tax Court on the cases dealing with patronage dividends by cooperatives, none of which were concerned with a threatened or an actual renegotiation of a cooperative's income under the Renegotiation Act of 1942.

7. The failure of the Tax Court of the United States to recognize that, notwithstanding that the taxpayer is an accrual basis taxpayer, certain of the concepts and cases decided under the principle of "constructive receipt" of income by cash basis taxpayers are relevant and persuasive by way of analogy.

8. The making and entry by the Tax Court of the United States of its decision of April 25, 1950.

9. The failure of the Tax Court to find that these credits from Pacific Forest Industries were not taxable income to taxpayer, Harbor Plywood Corporation, until paid in cash; or, in the alternative, the failure of the Tax Court to find, under the true rule of "accrued income," that when the credit memoranda were issued, the taxpayer had no fixed and unconditional right to the amount of each memorandum because at such time

(a) there was a contingency which might preclude ultimate payment, namely, the possible Renegotiation of Pacific Forest Industries;

(b) no reasonable expectancy that the right

would be converted into money could exist so long as such unresolved and intervening legal right as was created by the Renegotiation Act itself was not barred by the statute of limitations; and

(c) there was the further contingency which precluded payment imposed by Pacific Forest Industries itself, namely, the fact that it notified the taxpayer in writing that each credit memorandum was issued "subject to renegotiation;"

and, therefore, the amounts represented by said credit memoranda could not be accrued as taxable income by the taxpayer, Harbor Plywood Corporation, until the statute of limitations barred the Renegotiation of Pacific Forest Industries' income.

ARGUMENT

A.

The true rule of accrued income governs the case at bar and is as follows: Income accrues to a taxpayer when there arises to him a fixed or unconditional right to receive it and where there is no contingency or uncertainty that may preclude ultimate payment; that no income accrues unless there is a reasonable expectancy that the right will be converted into money and that no such reasonable expectancy can exist so long as there is an unresolved and allegedly intervening legal right which makes receipt contingent. (Assignments of Error I, II, IV.)

None of the three credit memoranda issued by Pacific Forest Industries to Harbor Plywood Corporation were taxable income to Harbor Plywood Corporation under Internal Revenue Code, Sections 22 (a), 41 and 42 (a) and the regulations thereunder (See Appendix A) at the date of their issuance. Under the application of the true rule of accrued income above stated and according to the stipulated facts in this case and the finding of fact of The Tax Court with which the petitioner is in complete agreement, namely, that each credit memorandum was issued subject to the same restriction as to payment, namely, it was issued "subject to Renegotiation" (R. 128), the taxpayer, Harbor Plywood Corporation, had no fixed and unconditional right to the amount of each Pacific Forest Industries' credit memorandum when each memorandum was issued because at such time there was a contingency which might preclude ultimate payment, namely, the possible Renegotiation of Pacific Forest Industries

under the Renegotiation Act of 1942; that no reasonable expectancy that the right would be converted into money could exist so long as such unresolved and allegedly intervening legal right as was created by the Renegotiation Act itself was not barred by the statute of limitations. In addition, there was the contingency which precluded payment and which was imposed by Pacific Forest Industries itself at the time each credit memorandum was issued, namely, as The Tax Court properly found, the fact that each memorandum was issued "subject to Renegotiation," and as such, the taxpayer's right to each memorandum was conditional and not accruable. This, then, is the crux of this case.

The evolution and development of this true rule of accrued income apparently escaped The Tax Court in its deliberations notwithstanding the careful presentation of its development by the petitioner. The Tax Court failed to realize and to apply the fundamental corollary of such true rule, namely, that such conditional or contingent income cannot be taxed until it is shorn of its conditional or contingent quality and has become unconditional or absolute.

This Ninth Circuit Court of Appeals has already agreed with the above stated true rule of accrued income in the cases of *H. Liebes and Co. v. Commissioner*, 90 F. (2d) 932, affirming 34 B.T.A. 677. It is true that The Tax Court in its opinion (R. 129-130) recognized and quoted from the *Liebes* case, but it is submitted that it misapplied the principle. Therefore, petitioner believes it necessary to make a review to this court of the cases properly setting forth this rule.

The most frequently cited case is *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182, where the United States Supreme Court said:

“Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, imports that it is the right to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues.”
(Pages 184-5)

To properly decide the case at bar it is actually necessary to cite only one additional case, namely the *Liebes* case referred to above, decided, as previously mentioned, by this Ninth Circuit Court of Appeals. The *Liebes* case contains a thorough review of all the leading cases on the subject and therefore will be quoted extensively below in this brief, thus eliminating the necessity of encumbering this brief with numerous citations and quotations.

That case involved litigation, which was authorized by statute, against the United States. The petitioner in that case had obtained a judgment in 1928, but the appeal period did not expire and no funds were available to pay the judgment until the end of the petitioner's fiscal year ending January 31, 1930, when it received payment. The petitioner had argued that the amounts were properly reportable on an accrual basis in the years in which the judgment was rendered, which was prior to the taxable year. The court held that such was not the case and the items could not be accrued in any prior year, but rather were reportable only when

the time for appeal had expired and when the amounts were paid. The Court of Appeals affirmed.

Before considering the language of the Circuit Court in the *Liebes* case, it is well to consider the language of the Board of Tax Appeals on this point which is particularly pertinent and is as follows:

“ ‘A mere contingent claim, especially a contested one, whether of gain or loss, may never be sustained or realized; it is too uncertain to be considered in making up an income tax return.’ *Commissioner v. Southeastern Express Co.*, 56 Fed. (2d) 600. To the same effect are *Commissioner v. Brown*, 54 Fed. (2d) 563, and *Buffalo Union Furnace Co. v. Helvering*, 72 Fed. (2d) 399. All of these cases involved sums concerning which there was litigation and the substance of the holdings is that during litigation the taxpayer’s rights were too uncertain to warrant accrual. We do not read the case of *Lichtenberger-Ferguson Co. v. Welch*, 54 Fed. (2d) 570, as opposed to the decisions above cited. In that case the taxpayer was awarded a sum by the War Department in 1919 for cancellation of a war contract. Due to some confusion in the War Department the check covering the award was not received by the taxpayer until 1920. There was no dispute or litigation concerning the award after it was made by the War Department, and the court, finding that ‘the adjustment made in August, 1919, was a final adjustment,’ held it to be accrued income in 1919. Similarly, in *Automobile Insurance Co. v. Commission*, 72 Fed. (2d) 265, the taxpayer accrued in 1928 the amount of an award by the Mixed Claims Commission, United States and Germany. It received a substantial payment on the award in that year, and it does not appear that

there was any contest, litigation, or other contingency respecting the taxpayer's right to the amount awarded. The Circuit Court sustained the accrual in 1928, quoting *Spring City Foundry Co. v. Commissioner*, 292 U. S. 192, that 'it is the right to receive and not the actual receipt that determines the inclusion of the amount in gross income.' Here the taxpayer's 'right to receive' was not established until February, 1929, which was within its fiscal year ended January 31, 1930.

"In No. 17541 suit was brought directly by the petitioner and judgment was rendered for the petitioner on December 28, 1928. The parties stipulate that no appeal was taken by the United States. However, they do not stipulate that any final settlement or agreement not to appeal was reached within the petitioner's fiscal year 1929. The appeal period of three months (§226, 230 U.S.C.A.) did not expire until in petitioner's fiscal year ended January 31, 1930, and in the absence of any act by the parties the judgment would not become final until the expiration of that period. At the time the judgment was rendered there was no appropriation available to satisfy it, and the funds were not appropriated until in petitioner's fiscal year ended January 31, 1930. Under these circumstances we are of the opinion that this judgment, like the others, was surrounded by too many contingencies and uncertainties to warrant. Apparently the petitioner thought so too, as it did not accrue any of the items on its books and did not accrue any of the items on its books and did not report them as income in the years in which it now says they were accruable." (pp. 682-683)

The Ninth Circuit Court of Appeals, in the *Liebes*

case, affirmed the Board of Tax Appeals and, in considering the same question which this court has before it in the case at bar, namely, when did the income accrue, said (90 F. (2d) 932 at pp. 936-938):

“Fourth. The principal issue is the time when the income accrued. Before discussing the specific contentions, we examine that question.

“It is apparent that the word ‘accrued’ may differ in its meaning, according to its use.

“In 1 Bouv. Law Dict. (Rawle’s Third Rev.) 111, the word ‘acrued’ is defined as follows:

“ ‘To grow to; to be added to; to become a present right or demand * * *

“ ‘To rise, to happen, to come to pass * * * ’

“In 1 C.J.S., Accrued, p. 761, it is said:

“ ‘Accrued,’ as the past tense or preterit of the verb, has been defined as meaning: Acquired; arose; became due; became vested; came into existence; existed; fell due; has arisen; made or executed; matured; occurred; received; vested; was created; was incurred; was in existence * * * ’

“As a general statement, the word ‘arose’ seems most expressive. However, such a general definition must be considered in connection with the use of the word. We must, therefore, determine what is meant by the words ‘income accrued’ as used with reference to income tax returns.

“The act does not define or provide when income accrues. In *United States v. American Can Co.*, 280 U.S. 412, 417, 50 S.Ct. 177, 179, 74 L.ed. 518, it is said that the taxpayers kept their books on ‘the accrual basis—that is, pecuniary obligations payable to or by the company were treated as if discharged when incurred.’ In *Lucas v. North*

Texas Lumber Co., 281 U.S. 11, 13, 50 S.Ct. 184, 185, 74 L.ed. 668, we are informed that income does not accrue until there is 'unconditional liability' on behalf of a party to pay it to the taxpayer. In *Continental Tie & L. Co. v. United States*, 286 U.S. 290, 295, 52 S.Ct. 529, 530, 76 L.ed. 1111, it is indicated that income accrues, when there is a 'right to payment.' In *North American Oil Consol. v. Burnet*, 286 U.S. 417, 424, 52 S.Ct. 613, 615, 76 L.Ed. 1197, it is said: 'If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.' In *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182, 184, 54 S.Ct. 644, 645, 78 L.ed. 1200, it is said: 'Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the right to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues.' In *United States v. Safety Car Heating & Lighting Co.*, *supra*, 297 U.S. 88, 93, 94, 56 S.Ct. 353, 356, 80 L.ed. 500, it is indicated that income accrues when the liability is uncontested and certain.

"In *Lichtenberger-Ferguson Co. v. Welch*, (C.C.A. 9) 54 F. (2d) 570, 572, this court said:

" 'Under the accrual system of accounting, where an item is definitely ascertained as to its amount, and acknowledged to be due, it has "accrued." To quote from the decision of the United

States Board of Tax Appeals in the case of Appeal of Clarence Schock, 1 B.T.A. 528, "Under such system of accounting receipt of income—actual or constructive—is not essential to constitute income within the statutory definition of income. Under an accrual system of accounting one accrues income, he does not receive it. Under the receipts and disbursements method, one receives income and does not accrue it". (pp. 936, 937)

"From the above expressions, it is apparent that the general definition of 'accrued' is limited when taken in connection with income returns. We may conclude that income has not accrued to a taxpayer until there arises to him a fixed or unconditional right to receive it.

"So far, only the right to receive has been considered. *Must we also consider the prospect of realization on that right by the taxpayer? In other words, when the right to receive arises, should the fact that the right is or is not collectible be taken into consideration in determining whether income has accrued? We believe that no income accrues unless there is a reasonable expectancy that the right will be converted into money or its equivalent.* Commissioner v. Brown, (C.A.A. 1) 54 F. (2d) 563; Corn Exchange Bank v. United States, (C.A.A. 2) 37 F. (2d) 34; Automobile Ins. Co. v. Commissioner (C.C.A. 2) 72 F. (2d) 265, 267; Commissioner v. Brooklyn R. S. Corp. (C.C.A. 2) 79 F. (2d) 833, 834; 1 Paul & Mertens, Law of Federal Income Taxation, 557, §11.73. See, also, American Cigar Co. v. Commissioner (C.C.A. 2) 66 F. (2d) 425, 426, certiorari denied 290 U.S. 699, 54 S.Ct. 209, 78 L.ed. 601; Helvering v. Russian Finance & Construction Corp. (C.C.A. 2) 77 F. (2d) 324, 327.

“The complete definition would therefore seem to be that income accrues to a taxpayer, when there arises to him a fixed or unconditional right to receive it, if there is a reasonable expectancy that the right will be converted into money or its equivalent.” (pp. 937, 938) (Emphasis supplied).

The petitioner also believes that the inapplicability of the so-called Federal control cases upon which respondent relies is quite simply demonstrated by the following language of the Circuit Court in the *Liebes* case where it said as follows:

“Petitioner contends that the income accrued, at the time when the interference by the United States occurred, namely during the years 1891, 1892 and 1893, not on the theory, as we understand it, that the right to receive such income was fixed and unconditional, but on the analogy of *Southern Ry. Co. v. Commissioner*, (C.C.A. 4) 74 F. (2d) 887, and *Helvering v. Gulf M. & N. R. Co.*, 63 App. D.C. 244, 71 F. (2d) 953. In those cases it is held that compensation received by railroads for federal control during the war period accrued proratably over the entire period of control. Those cases are merely examples of the rule. The Federal Control Act (Act of March 21, 1918, c. 25, §1, 40 Stat. 451) fixed the right to receive the income for the entire period of federal control. *Southern Ry. Co. v. Commissioner*, (C.C.A. 4) 74 F. (2d) 887, 893, *supra*; *Continental Tie & L. Co. v. United States*, 286 U.S. 290, 295, 52 S.Ct. 529, 530, 76 L. ed. 1111, although decided under a different act is analogous and is authority for the conclusion reached.” (p. 938)

In the Federal Control cases the certainty of income

was fixed by statute. In our renegotiation case the uncertainty of income was fixed by statute and continued until the statute of limitations barred the effect of the statute.

The petitioner also feels that the analogy between the problem confronting the court in the *Liebes* case as regards the finality of judgment and the right to income during the period in which an appeal might be effected, and the problem confronting this court in the case at bar as regards the actual threat of renegotiation which hung over the head of Harbor Plywood Corporation during the possible period of one year in which renegotiation of P.F.I. might occur, is so strong as to justify the following further quotation from the *Liebes* case relating to the effect of a possible appeal and reversal of judgment upon the right and duty to accrue income. In that connection, the *Liebes* case said, at pages 938-939:

“Fifth. With respect to the action in which petitioner recovered judgment, it seems to be conceded that income therefrom accrued to petitioner in the fiscal year prior to the one ending January 31, 1930, unless the right to receive, fixed by the judgment, was conditional. Respondent contends that the right was conditional, because (1) the judgment might be reversed on appeal, and, therefore, it was not unconditional until the time for appeal had expired, which in such case was in the fiscal year ending January 31, 1930; and (2) there was no appropriation to satisfy the judgment until during the fiscal year ending January 31, 1930.

“Did the right to receive become fixed or unconditional at the time judgment was entered, or when

the time within which an appeal might be taken had expired?

“It is clear that where a claim exists, no income may accrue, in the absence of a settlement, so long as a judgment has not been entered. *Lucas v. American Code Co.*, *supra*, 280 U.S. 445, 450, 50 S.Ct. 202, 203, L.ed. 538, 67 A.L.R. 1010; *North American Oil Consol. v. Burnet*, *supra*, 286 U.S. 417, 423, 52 S.Ct. 613, 615, 76 L.ed. 1197; *United States v. Safety Car Heating & Lighting Co.*, *supra*, 297 U.S. 88, 99, 56 S.Ct. 353, 358, 80 L.ed. 500; *Commissioner v. Brown*, (C.C.A. 1) 54 F. (2d) 563, 567, *supra*; *Buffalo Union Furnace Co. v. Helvering*, (C.C.A. 2) 72 F. (2d) 399; *Commissioner v. Southeastern Express Co.*, (C.C.A. 5) 56 F. (2d) 600; *J. N. Pharr & Sons v. Commissioner*, (C.C.A. 5) 56 F. (2d) 832; see, also, *Commissioner v. John Thatcher & Son*, (C.C.A. 2) 76 F. (2d) 900. *Commissioner v. Highway Trailer Co.*, (C.C.A. 7) 72 F. (2d) 913, is an example where the same principle is applicable. The same may be said for *Board v. Commissioner*, (C.C.A. 6) 51 F. (2d) 73, and *Massey v. Commissioner*, (C.C.A. 7) 51 F. (2d) 76. This rule seems to coincide with what is considered to be proper accounting practice. Ronald, *Accountant's Handbook* (2d Ed.) p. 298.

“Approaching the other end of the process of litigation, we have for consideration the case where the claim has been reduced to judgment but an appeal has been taken. *United States v. Safety Car Heating & Lighting Co.*, *supra*, 297 U.S. 88, 99, 56 S.Ct. 353, 358, 80 L.ed. 500, we believe establishes the rule, namely, that no income accrues until the appeal is determined. Compare *Commissioner v. Brown*, (C.C.A. 1) *supra*; *Commissioner v. John*

Thatcher & Son, (C.C.A. 2) 76 F. (2d) 900, 902, *supra*; *Commissioner v. Southeastern Express Co.*, (C.C.A. 5) *supra*; *Central Trust Co. v. Burnet*, 60 App. D.C. 4, 45 F. (2d) 922, 923.

“As to the situation lying between the two mentioned, that is where judgment is entered, and no appeal has been taken, but the time within which an appeal might be taken has not expired, we find no cases directly in point. If appeal is taken, the right is not fixed until determination of the appeal; and if no appeal is taken, the right is fixed. *We believe in the latter situation that the right becomes fixed on termination of the appeal time.* This seems to coincide with the actual practice of the government, as shown by provisions regarding payment of judgments rendered against the United States. It is usually provided that payment will not be made until the time for appeal has expired. Treasury Regulations 86 and 94, Arts. 322-325; Act March 4, 1933, §2, 47 Stat. 1602, 1616; Act Aug. 12, 1935, §2 (d) 49 Stat. 571, 602.

“With respect to the contention that the absence of an appropriation makes the right conditional, we believe that such fact does not affect the right, but the realization of the right. Even if the judgment remained unpaid, the right would not be impaired. But the absence of an appropriation may be considered in connection with the condition in the general definition hereinabove mentioned, that there must be a reasonable expectancy that the right will be converted into money or its equivalent. Respondent points out that Congress has refused to make an appropriation to satisfy the judgment rendered January 12, 1931 in *Dalton v. United States*, 71 Ct. Cl. 421 (75 Cong. Rec. Part 2

pp. 1233, 1307; 79 Cong. Rec., Part 10, p. 10816). Respondent says, however, that he 'does not wish even to seem to contend that the legislative branch of the government does not usually appropriate moneys to satisfy judgments rendered against the United States'. It is inconceivable that Congress would go through the idle ceremony of enacting a statute authorizing the suits in question, and subsequently render it nugatory by the failure to make an appropriation. We believe that when the appeal time expired, there was a reasonable expectancy that the right would be converted into money.

"In conformity with the foregoing, we hold that income from petitioner's claim on which it recovered judgment, accrued to petitioner during the fiscal year ending January 31, 1930." (pp. 938-939) (Underlining supplied).

So it is in the case at bar. The period of possible renegotiation of P.F.I. is similar to the period of possible appeal from the judgment in the *Liebes* case. During such period of possible renegotiation of P.F.I., Harbor's right to the income was conditioned and could not be accrued. The fact that no renegotiation of P.F.I. occurred does not change the result just as the Court in the *Liebes* case pointed out that the failure to appeal from the judgment makes no difference. Just as the court said "that the right becomes fixed on termination of the appeal time," so here Harbor's right became fixed on termination of the renegotiation time for P.F.I., namely, at the end of the one-year period of limitation.

If actual renegotiation of P.F.I. had been taking place, the situation would have been identical with the

situation discussed in the *Liebes* case of a judgment with an appeal actually taken and pending. As pointed out in the *Liebes* case, *U. S. v. Safety Car Heating & Lighting Co.*, 297 U.S. 88, 99, establishes the rule that no income accrues in such a situation until the appeal is determined. This in effect is the exact situation recently recognized and approved by the Tax Court as regards the effect of actual renegotiation in *Lester C. Smith & Mary B. W. Smith v. Commissioner*, 8 T.C.M. 385 (1949), discussed hereinafter.

The petitioner now submits that the following cases, which take the *Spring City Foundry* rule and amplify and refine it in language as set forth at the beginning of this phase of the argument in the Petitioner's Brief, should be examined. These cases are:

Georgia School Book Depository, Inc. v. Commissioner, 1 T.C. 463 (decided January 19, 1943);

Fifth Street Store, 6 T.C. 644 (1946);

San Francisco Stevedoring Co., 8 T.C. 222 (1947);

Cuba Railroad Co., 9 T.C. 211 (1947);

William Justin Petit, 8 T.C. 228 (1947); and

Lester C. Smith (deceased), Mary B. W. Smith, Testamentary Executrix v. Commissioner, and *Mary B. W. Smith v. Commissioner*, 8 T.C.M. 385 (1949).

Turning then to the first of these cases, *Georgia School Book Depository, Inc.*, 1 T.C. 463, we find a case involving a simple question of whether the taxpayer

which was an accrual basis taxpayer, should have accrued certain school book commissions at the time the books were sold by the publishers to the State of Georgia, or should have returned them as income only when the books were paid for by the State as the petitioner contended. Under the facts there presented the court held adversely to the petitioner and held that the items should be accrued as soon as the books were sold notwithstanding that at that time the State treasury had insufficient funds with which to make the required payment. The Tax Court, however, rightly recognized the existence of "the reasonable expectancy" exception to the *Spring City Foundry* case definition of accrued income and, commenting on that point, the Tax Court used the following language (1 T.C. 463, at pp. 468-9):

"We pass, then, to the second question, whether there was a reasonable expectancy that the claim would ever be paid. *Where there is a contingency that may preclude ultimate payment, whether it be that the right itself is in litigation or that the debtor is insolvent, the right need not be accrued when it arises.* This rule is founded on the old principle that equity will not require a suitor to do a needless thing. The taxpayer need not accrue a debt if later experience, available at the time that the question is adjudged, confirms a belief reasonably held at the time the debt was due, that it will never be paid. *Corn Exchange Bank v. United States*, 37 Fed. (2d) 34 (2d Cir.); *H. Liebes & Co. v. Commissioner*, 90 Fed. (2d) 932 (9th Cir.), and cases there cited at page 937. On the other hand, it must not be forgotten that the alleviating principle of 'reasonable expectancy' is, after all, an excep-

tion, and the exception must not be allowed to swallow up the fundamental rule upon which it is engrafted requiring a taxpayer on the accrual basis to accrue his obligations, *Spring City Foundry Co. v. Commissioner, supra*. If this were so, the taxpayer might at his own will shift the receipt of income from one year to another as should suit his fancy. Cf. *Clifton Manufacturing Co.*, I.T.C. 71. *To allow the exception there must be a definite showing that an unresolved and allegedly intervening legal right makes receipt contingent or that the insolvency of his debtor makes it improbable.* Postponement of payment without such accompanying doubts is not enough. * * *." (pp. 468-469) (Underlining supplied).

The court then went on to comment upon and quote with approval much of the language of the *Liebes* case which the petitioner has set forth in this brief above.

Following the language of the *Georgia School Book* case, the petitioner, Harbor Plywood Corporation, asserts that in the case at bar "there is a contingency that may preclude ultimate payment," which affected petitioner's right to this income, namely, the very real contingency at the times in question that all of P.F.I.'s income could and might be renegotiated. Such a contingency could not possibly be eliminated prior to the expiration of the statute of limitations on the renegotiability of P.F.I. Further, Harbor Plywood asserts that there was "a definite showing that an unresolved and allegedly intervening legal right makes receipt contingent * * *," and that such intervening legal right was the Renegotiation Act of Congress itself which

superimposed a legal condition upon Harbor's right to receive this income until it was barred by the statute of limitations. The condition imposed by the Act of Congress was reinforced by the affirmative act of P.F.I. itself in issuing each credit memorandum conditionally by making it specifically "subject to renegotiation."

In passing it might be well to note that the Tax Court, in the case of *Fifth Street Store*, 6 T.C. 664 (1946), used the following language to define accrued income (p. 679):

"But in order for a claim to be accruable, both the liability and the amount must be certain at the time or sufficiently ascertainable. *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182; *Lucas v. North Texas Lumber Co.*, 281 U.S. 11; *H. Liebes & Co. v. Commissioner*, (C.C.A., 9th Cir.), 90 Fed. (2d) 932."

In the *San Francisco Stevedoring* case is to be found the following language:

" * * * A taxpayer, using an accrual method of accounting, must accrue an item in the year in which the taxpayer acquires a fixed and unconditional right to receive the amount, even though actual payment is to be deferred. There must be no contingency or unreasonable uncertainty qualifying the payment or receipt. Income does not accrue to a taxpayer using an accrual method until there arises in him a fixed or unconditional right to receive it. *United States v. Anderson*, 269 U.S. 422; *Continental Tie & Lumber Co. v. United States*, 286 U.S. 290; *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182; *United States v. Safety Car Heating & Lighting Co.*, 297 U.S. 88; *Putnam's*

Estate v. Commissioner, 324 U.S. 393; *H. Liebes & Co. v. Commissioner*, 90 Fed. (2d) 932; Mertens Law of Federal Income Taxation, Sec. 12.60. The time when an item accrues is largely a question of fact, to be determined in each case. It is hereby found as an ultimate fact, that the item here in question did not accrue in 1939." (pp. 225-226)

And, it is well to continue this quotation, in part, so far as it is relevant to the case at bar, and point out that even where the amount may be fixed (and, of course, the exact amount was not fixed in the case at bar because of the threat of renegotiation) that does not determine that the amount shall be accrued. On that point the *Stevedoring* case uses the following language:

"It could not have been said in 1939 that there was *no contingency or unreasonable uncertainty qualifying the payment to the petitioner of the amount in question*. Coast had apparently supplanted San Francisco to the extent, at least, that San Francisco no longer needed this surplus of \$145,000. If San Francisco had been liquidated at that time, all of the \$145,000 would have been paid to members of San Francisco who were also members of Coast. Coast needed this money in order to carry on the labor relations of those members. *The amount which the petitioner was to get was fixed, but, so far as this record shows, it was not only uncertain in 1939 as to just when Coast would pay the money to the petitioner, but it was also uncertain as to whether it would ever pay it*. It is stated in the stipulation of facts that Coast needed the money to carry on its activities more effectively and to replace the 'existing deficit' in its treasury. If it did not realize income, it would not be able

to make the payments. * * *” (p. 226) (Emphasis supplied)

In the case at bar not only was the exact amount not fixed but also it was uncertain, until the period of limitations on renegotiation had expired, as to whether P.F.I. would ever pay and P.F.I. had made such uncertainty emphatically known to the taxpayer by issuing each credit memorandum “subject to renegotiation.”

The *Cuba Railroad* case, 9 T.C. 211 (1947) is to the same effect as the *Stevedoring* case and holds that a taxpayer using an accrual method of accounting does not have to accrue an item where it appears at the end of the taxable year that there is real doubt as to the collectibility of the item. In the brief opinion of the Tax Court in the *Cuba Railroad* case the language from the *Stevedoring* case quoted above was quoted with approval and it was pointed out that even though the amount may be fixed, where there is uncertainty as to whether the amount would ever be paid, it need not be accrued until the uncertainty is removed in some way. In the case at bar such uncertainty could not be eliminated until the period for renegotiation of P.F.I. had expired.

Following the *Stevedoring* case we find another recent Tax Court decision analyzing the concept of accrued income. It is *William Justin Petit*, 8 T.C. 228 (1947) where the following language appears at page 233 of the opinion:

“When a taxpayer is on the accrual basis it is the right to receive the income and not the actual receipt that determines the inclusion of the amount

in gross income. *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182. However, in order for items to be accrued as income the event must occur which determines the amount due. When the amount to be received depends upon a contingency or future events, it is not to be accrued until such contingency or the events have occurred and fixed with reasonable certainty the fact and amount of income. *U. S. Cartridge Co. v. United States*, 284 U.S. 511." (p. 233)

Shortly after the *Cuba Railroad* case was decided the language quoted above from the *William J. Petit* case was quoted with approval by the Tax Court in the case of *Luckenbach Steamship Co.*, 9 T.C. 662, at page 675. Precisely as is pointed out in the quoted language above, in order for items to be accrued the event must occur which determines the amount due, and, as pointed out above, the event which had to occur to determine the amount due the petitioner by P.F.I. was the expiration of the period for possible renegotiation of P.F.I. Until that event occurred the amount due the taxpayer was not fixed with any degree of certainty and hence could not be accrued.

This abbreviated chronology of the development of the true rule of accrued income brings the petitioner to the last case in the sequence, namely, *Lester C. Smith (deceased), Mary B. W. Smith, Testamentary Executrix, v. Commissioner and Mary B. W. Smith v. Commissioner, supra*. It is true that the taxpayer in that case was a cash basis taxpayer rather than an accrual basis taxpayer, but it is submitted that this case, because it is the only case which the petitioner has been

able to find dealing with the Renegotiation question here in issue, is particularly pertinent. Especially is this so when the concept of constructive receipt as applied to a cash basis taxpayer is not greatly different from the concept of accrual as applied to an accrual basis taxpayer.

In that case the taxpayer, an employee, executed an agreement with the partnership by which he was employed, under the terms of which he was to receive a base salary plus 12.19% of the profits, subject to maintenance of reserve for losses at a specified level. During the years 1942 and 1943 the partnership was engaged in the construction of maritime facilities under contracts which were subject to profits' Renegotiation. Renegotiation was in process in 1943 and was not concluded until 1946. During 1943, the taxpayer's share of profits in such contracts was included in other credits to a special account on the employer's books in which the employee's 12.19% share of profits was recorded. Certain amounts were withdrawn by the employee—taxpayer and a portion of the balance was required to be maintained as the taxpayer's share of the loss reserve. By agreement of the parties the excess of the amount credited to the special account over withdrawals was not to be withdrawn until the conclusion of Renegotiation fixed definitely the amount of the taxpayer's 12.19% share in the profits from the contracts being Renegotiated. The Commissioner in that case, just as in the case at bar, contended that this balance had been constructively received in 1943 and was therefore includable in the taxpayer's income for that year. The Tax

Court, however, in that case, in curious contrast to the attitude in this *Harbor Plywood Corporation* case at bar, refused to sustain the Commissioner and held that the agreement restricting the withdrawal was to be given equal consideration with the agreement giving the taxpayer a 12.19% share of the profits, and, since it had been proven that there was such an agreement restricting withdrawals in the year 1943 (just as there were restrictions limiting Harbor Plywood's right to withdraw the funds from Pacific Forest Industries by virtue of the credit memorandums being issued, as The Tax Court properly found, "subject to Renegotiation" in each year) there was no constructive receipt of additional compensation in that year. It is submitted that a more analogous case in support of the petitioner's alternative contention in the case at bar could hardly be found and that the *Smith* case, together with the *Liebes* case, is all that this Court needs to hold in favor of the petitioner's alternative contention. It should also be noted that in the *Smith* case the Tax Court addressed itself, and quite properly so, only to the taxpayer-employee's method of accounting and the opinion makes no mention of whether the amounts so credited to the employee's account were claimed and allowed as a deductible salary expense by the employer. It is to be assumed from the analysis of the employee's account on the employer's books, as set forth in the opinion, that the employer claimed and was allowed a deduction for the employee's share in the profits, subject to Renegotiation, notwithstanding the fact that until such Renegotiation was completed there was no figure against

which the employee's percentage could positively apply and hence there was no exact amount of income to which the employee had an unconditional right. As far as the impact of Renegotiation in the *Smith* case and in the case at bar is concerned, it seems equal in force in both cases and the fact that in one the taxpayer was a cash basis taxpayer and in the other the taxpayer was an accrual basis taxpayer would seem, so far as such impact of Renegotiation was concerned, to be a distinction without a difference. So, too, the fact that in the *Smith* case the Court was concerned with an actual Renegotiation and that the case at bar involves a threatened and probable (not merely possible) Renegotiation is, too, a distinction without a difference. It is interesting to note that nowhere in the opinion of the Tax Court in the case at bar was any reference made to the *Smith* case nor was any attempt made to distinguish it (notwithstanding that such case was cited emphatically by petitioner). Petitioner respectfully submits that the doctrine of the *Liebes* case and of the *Smith* case can and should be applied to the case of the taxpayer here, Harbor Plywood Corporation.

Stated simply, this Court should reaffirm the principle and apply it to the facts which have been found and this Court should hold that where an accrual basis taxpayer is due to receive an uncertain amount, if any, from another corporation, which other corporation is threatened with Renegotiation of its income under the Renegotiation Act, such taxpayer has no fixed or unconditional right to a determinable amount of income; and, further, that there is no reasonable expectancy,

even if the right is found to exist, the right will be converted into money or its equivalent until that contingency of Renegotiation, which may preclude ultimate payment and which arises by operation of Congressional enactment and by the continued persistent and active written and oral threats of those administering such act, is eliminated or barred by the period of limitations governing such Renegotiation. Just as in the *Liebes* case the right to the income did not become fixed until the period for appeal from the judgment in favor of the taxpayer had expired, so, too, here the right to the income had not become fixed until the Government's right to renegotiate the income of Pacific Forest Industries had expired under the applicable one-year period of limitations.

The rule of law asserted by the petitioner at the opening of this part A of the Argument is, it is submitted, an accurate statement of the true rule of accrued income. It is amply supported by the *Liebes* case decided by this Ninth Circuit Court, by the leading United States Supreme Court and other Federal Court decisions cited in detail in the *Liebes* case, and by the leading text authorities such as Mertens, "Law of Federal Income Taxation," Vol. 2 (and 1950 Cum. Pocket Supp.) §§12.60-12.65; §§12.75-12.77; Rabkin and Johnson, "Federal Income, Gift and Estate Taxation," pp. 704, 707-8, 709b, 712. To the same effect is an early ruling of the Bureau of Internal Revenue, L.O. 1086, 1-1 CB 87. When properly applied to the facts in this case, this true rule of accrued income supports the taxpayer's alternative contention and justifies reversal of the Tax Court.

B.

The Tax Court erred in its opinion in stating that the threat of renegotiation was a “mere possibility of renegotiation”. Such statement is contrary to the evidence. Such renegotiation was not only possible but highly probable. (Assignment of Error III.)

The problem before this court arises from Treasury Procurement's threats to renegotiate all of Pacific Forest Industries' contracts during the tax years in question. That such threatened renegotiation was actual, strong, continued and definite there can be no doubt (See Joint Ex. 5-E (R. 57), 7-G (R. 64), 8-H (R. 70) and 11-K (R. 77)). Because the Treasury Department had asked and continued to ask for Renegotiation, it was not only possible but highly probable.

Pacific Forest Industries emphatically asserted at all times, both by correspondence and by personal conferences with the Chairman of the Treasury Department Price Adjustment Board by Pacific Forest Industries' General Manager and legal counsel, that it was not subject to renegotiation under the Renegotiation Act. (See Joint Ex. 7-G (R. 64)), and testimony of Mr. Schweppe (R. 111, 113). In spite of its repeated and emphatic assertions to the contrary, Pacific Forest Industries was told by the Treasury Department Procurement Division, in person and by letter (R. 65), that it was subject to renegotiation and, further, that it was required to submit certain data and annual reports in relation thereto. Note in particular the emphatic statement to be found in the letter dated June 4, 1943, from the Chairman of the Treasury Department Price Ad-

justment Board to Pacific Forest Industries (Joint Ex. 7-G (R. 64-66)), wherein it was said:

“Reference is made to your letter of April 24, 1943, in which you state that Pacific Forest Industries is exempt from income tax payments through the Board of Tax Appeals in Docket No. 99742 dated November 4, 1941.

“After a review of the Docket mentioned Procurement Division’s Legal Staff has advised that the opinion rendered by the Board of Tax Appeals in this case only indicates a certain sum of money received by the contractor from its producer mills for the purpose of reducing an operating deficit incurred in its prior fiscal year was excludable from gross income for that taxable year. Hence, it appears that the Docket opinion is no basis to exempt your company. Consequently, *I am directed to require that your accounts be renegotiated.*” (Emphasis supplied)

Treasury Procurement insisted that because P.F.I. was the only party to the contract, it was the only party to be recognized by Treasury Procurement and that it was, therefore, subject to renegotiation under the Renegotiation Act.

The petitioner wishes also to stress the fact that Pacific Forest Industries could derive no particular comfort from the letter from the Treasury Department Price Adjustment Board dated June 21, 1944 (Joint Ex. 11-K (R. 77)). That letter indicated that there would quite probably be no renegotiation for Pacific Forest Industries’ fiscal year ending March 31, 1944 (not 1943 as erroneously stated in the letter, which dis-

crepancy is clarified by an examination of Joint Exs. 12-L (R. 79) and 13-M (R. 80)) because such letter went on to state that it was not a release of liability under the renegotiation statute. This left the threat of renegotiation hanging not only over the head of Pacific Forest Industries but over the heads of all of the members of Pacific Forest Industries as to export sales. It is, therefore, understandable and reasonable that Pacific Forest Industries should have been advised by its legal counsel, under date of June 27, 1944 (Joint Ex. 14-N (R. 81)) that no payments could be made by Pacific Forest Industries to its members until Pacific Forest Industries' liability for possible renegotiation was terminated by the applicable period of limitations on such renegotiation (Also see Mr. Schweppe's testimony, R. 22). Petitioner, Harbor Plywood Corporation, had full knowledge of the threatened renegotiation and approved of the delay in payment advised by counsel (R. 114-116).

It is submitted that under these circumstances both Pacific Forest Industries and the petitioner, Harbor Plywood Corporation, had ample reason for believing that Pacific Forest Industries might be subject to renegotiation and that, therefore, until either renegotiation was complete, or the statute of limitations had expired on renegotiation, the income of Pacific Forest Industries was not fixed and determined as to amounts and the petitioner, Harbor Plywood Corporation, had no fixed, unconditional and absolute, right to a refund of any portion thereof under any interpretation of the Internal Revenue Code or Regulations.

It is apparent, from the record in this case, to which reference is made above, that the threat of renegotiation was far more than a "mere possibility of renegotiation" as stated by the Tax Court in its opinion (R. 130). Such threatened renegotiation was actual, strong, continued, persistent and definite. There is no doubt as to that. Such renegotiation was highly probable. As stated in the dissenting opinion of Tax Court Judge Disney (R. 132-133):

"Obviously it was a probability for the Treasury Department had asked for it. The result of renegotiation was altogether problematical and contingent. In my opinion the taxpayer upon the accrual basis should not be required to accrue such an uncertain and contingent item."

While referring to portions of the majority and minority opinion on the degree of the " * * * possibility of renegotiation," another error of both law and fact by the Tax Court is readily apparent and requires correction on appeal by this Circuit Court.

Petitioner wishes to invite this Court's attention to the following strange language used by the Tax Court majority in its opinion below in the case at bar (R. 130):

" * * * There was no contingency as to the amount of income represented by the credit memorandums or of Pacific's right to receive it; *nor was there any contingency as to petitioner's right to whatever income might remain after renegotiation, should that occur.* The mere possibility of renegotiation did not give rise to a liability which either Pacific or the petitioner could have accrued on its books,

since it had not become fixed and was being strenuously protested by Pacific. No liability for renegotiation was set up in Pacific's books. *Conceding that there was a possibility of renegotiation, there was no way of even approximating the amount of excessive profits that might be claimed by the Government.*" (Italics supplied)

It is readily apparent that the quoted language is confused, illogical and contradictory. The use of the words " * * * whatever income might remain after renegotiation * * *" indicates that the Tax Court recognized that until Renegotiation was barred by limitations the exact dollar amount which Harbor Plywood would receive from P.F.I. was not only uncertain and indefinite but also might be zero.

But the Tax Court in stating " * * * nor was there any contingency as to petitioner's right to whatever income might remain after renegotiation * * *" was really saying, in effect, was it not?:

"Harbor Plywood had an unconditional right to an indefinite dollar amount which could vary all the way from the face amount of the credit memo down to and including zero, depending on the results of the Renegotiation of P.F.I. or on the expiration of the period of limitations on Renegotiation."

The result of renegotiation was completely problematical and contingent. That being so, petitioner fails to see how the Tax Court could logically render the decision which it did on the accrual of income by Harbor Plywood.

So, too, the second underlined portion of the above

quotation of the Tax Court language argues more strongly for the taxpayer's contention than for the Tax Court's opinion when it says that so long as there was a possibility of renegotiation " * * * there was no way of even approximating the amount of excessive profits that might be claimed by the Government." With this the petitioner agrees. During the period of possible renegotiation there was absolutely no way of computing what amount, if any, would be left for distribution by P.F.I. to Harbor Plywood and to the other stockholders holding the credit memorandums. Hence the amounts represented by such credit memos could not be accrued as income.

Meaning no disrespect to the Tax Court, the petitioner is completely at a loss to understand the fallacious reasoning of the Tax Court quoted above. Logically, it just does not support the decision rendered. Stated otherwise, it simply "puts the cart before the horse." Profit on the sales by P.F.I. to the Government for Lend-Lease (the Renegotiation of which profits, as the quoted language states, " * * * was being strenuously protested by Pacific.") had to be income first to Pacific Forest Industries before it could become income to Harbor Plywood, and not *vice versa* as the Tax Court seems to believe. With " * * * whatever income might remain after renegotiation * * *" being uncertain, indefinite and incapable of mathematical computation, and with there being absolutely "no way of even approximating the amount of excessive profits that might be claimed by the Government," how are the requirements for accruing income by Harbor Plywood satis-

fied? The true rule defined at the outset of this portion of the brief is violated in every respect by the quoted uncertainties.

Moreover, it is plain the Tax Court was badly confused in another particular when it said:

“The mere possibility of renegotiation did not give rise to a liability which * * * the petitioner could have accrued on its books since it had not become fixed and was being strenuously protested by Pacific.”

Of course there could be no liability by the petitioner, Harbor Plywood, but not for the reason given by the Tax Court. The reason is, we are concerned only with gross income accrual by petitioner; we are not concerned with expense deductions or liability accruals by petitioner. As to Harbor Plywood, the credit memos presented a problem of gross income accrual and not liability accrual. And, as pointed out hereafter in part D of the Argument, whether P.F.I. could not have or did not set up a liability for renegotiation is not in issue in this case and does not determine or control the petitioner's time for accruing income.

C.

The Tax Court erred in relying on the cases dealing with patronage dividends by cooperatives (R. 131), none of which cases were concerned with a threatened or actual renegotiation of a cooperative's income under the Renegotiation Act of 1942. (Assignment of Error VI.)

None of the cases set forth in the opinion of the Tax Court, namely, *San Joaquin Valley Poultry Producers*

Association, 136 F.(2d) 382; *Midland Cooperative Wholesale*, 44 B.T.A. 824; *United Cooperatives, Inc.*, 4 T.C. 93, involved the unique problem which is before this Court, namely, the renegotiation of a co-operative's income. Because of such possible and probable renegotiation, Pacific Forest Industries' right to income from Lend-Lease was as uncertain, conditional and contingent upon there being no renegotiation as was the taxpayer's right to its share in such income; Pacific Forest Industries' right to its income might, in the language of the *Liebes* case, be "reversed by appeal" so to speak, that is, reversed by Renegotiation. As demonstrated above, petitioner, Harbor Plywood Corporation, could not accrue such income from Pacific Forest Industries until the contingency of P.F.I.'s renegotiation was eliminated. To hold otherwise, as to the petitioner, Harbor Plywood Corporation, would be to raise Harbor Plywood Corporation's right to such income to a higher degree of certainty and to a more reasonable degree of expectancy than the source of such income itself. When so considered, from the standpoint of the only taxpayer who is a party to this litigation, namely, Harbor Plywood Corporation, the matter is reduced to an absurdity and the inapplicability of the patronage dividends' case is immediately apparent. If the co-operative's right to income was uncertain, conditional and contingent, how can the members of the co-operative possibly have a share in such income which is certain, unconditional and not contingent? To ask the question is to answer it. Such a situation is, of course, logically impossible and the co-operative, Pacific Forest Industries,

recognized this when it took affirmative action, as it was legally authorized to do, in specifically providing that its members share in such income was to be uncertain, conditional and contingent by issuing each credit memorandum, as the Tax Court properly found, "subject to renegotiation."

D.

The Tax Court erred in considering that the method of accounting and the time for deducting expenses by Pacific Forest Industries is in any way determinative of the method of accruing and the time for reporting income by the taxpayer, Harbor Plywood Corporation. (Assignment of Error V.)

The Tax Court further erred in failing to recognize that, notwithstanding that the taxpayer, Harbor Plywood Corporation, is an accrual basis taxpayer, certain of the concepts in cases decided under the principle of "constructive receipt" of income by cash basis taxpayers are relevant and persuasive by way of analogy to the case at bar. (Assignment of Error VII.)

The Tax Court seems to derive some comfort from its statement (R. 130) "no liability for renegotiation was set up in Pacific's books." and in its statement that the income represented by the credit memoranda " * * * had been credited to the petitioner on the books of Pacific when the credit memorandums were issued."

The petitioner respectfully invites this court's attention to the fact that Pacific Forest Industries is not a party to this litigation; the tax reporting of Pacific Forest Industries' income is not an issue and is not relevant to this inquiry, just as in the recent *Lester Smith*, case, *supra*, the employer's income and deduc-

tions were not in issue and were not considered. In the agreed stipulation of facts submitted to the Tax Court the petitioner reserved the right to object to the relevancy of the manner in which Pacific Forest Industries handled these amounts represented by the credit memorandums on its books of account (R. 28); and the Petitioner's counsel renewed its objection to the relevancy of paragraph 9 of the Stipulation of Facts at the time the case was tried to the Tax Court (R. 90-91), but this objection was overruled by the court. Petitioner submits the overruling of this objection was an error and submits further that Paragraph 9 of the Stipulation of Facts is *not* relevant to the case at bar. Harbor Plywood, the petitioner here, stoutly insists that Pacific Forest Industries' method of tax accounting of these particular credits which were subject to threatened renegotiation is in no way determinative of Harbor Plywood's method of reporting income. It is further submitted that a deduction or an exclusion from gross income by an accrual basis taxpayer has been squarely held not of itself to justify the application of the constructive receipt theory of reporting income to a cash basis payee, *Helvering v. Jane Holding Corporation* (C.C.A. 8) 109 F.(2d) 933; similarly, authorized but unpaid salaries by a corporation, were not taxable to a cash basis employee although the corporation kept its books upon the accrual basis and took a deduction for the salary authorized, *Bluthenthal*, 1 B.T.A. 173; and to the same effect *Karr*, 2 B.T.A. 635; *Greenbaum*, 2 B.T.A. 979; and *Farr*, 3 B.T.A. 110. These principles concerning constructive receipt reporting by cash basis

payees and their relation to another taxpayer, regardless of that other taxpayer's method of accounting, are equally applicable to accrual basis payees such as Harbor Plywood Corporation, the petitioner herein. (Constructive receipt is, in effect, what might be termed the accrual basis exception which is applied against cash basis taxpayers in certain circumstances and in particular with reference to wages which have been unconditionally credited to their account without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is made.) The principles in the foregoing cases simply add up to the proposition and rule that one taxpayer's method of reporting income is in no way related to nor determinative of a second and independent taxpayer's method of reporting income.

E.

The Tax Court erred in failing to realize and to find that, in addition to the fact that Pacific Forest Industries issued each credit memorandum "subject to renegotiation," no reasonable expectancy that the right represented by such memorandum would be converted into money could exist so long as the unresolved and intervening legal right as was created by the Renegotiation Act itself was not barred by the Statute of Limitations. (Assignment of Error IX-b.)

The Renegotiation Act itself created an independent supervening factor and established an unresolved and intervening legal right which prevented the creation of any reasonable expectancy that the right represented by the credit memorandum would be converted into

money until the statute of limitations on Renegotiation had run. By its enactment Congress had attached a contingent legal liability on Pacific Forest Industries' claims against the Government in which the petitioner, Harbor Plywood Corporation, hoped ultimately to share. Such liability, created by the supervening Renegotiation Act, imposed a definite condition on the credit memorandum in addition to that imposed by Pacific Forest Industries itself at the time of the issuance of the credit memoranda. It is submitted, therefore, that such credit memoranda were not unconditionally payable and that no enforceable legal action could have been maintained by Harbor Plywood Corporation against Pacific Forest Industries to collect these credit memoranda immediately after their issuance because such claims were not liquidated as to amount nor unconditionally payable. Not being immediately enforceable or collectible, they are certainly not includable in the petitioner's income until they are enforceable or collectible. Stated otherwise, until the act was barred by the period of limitations there was a contingency which might preclude ultimate payment, namely, the possible and probable Renegotiation of Pacific Forest Industries, and there was no reasonable expectancy that the right could be converted into money or its equivalent until passage of the period of limitations. Recognizing this fact, none of the nineteen member corporations brought any actions to enforce payment. No demands were even made. All members recognized the Renegotiation possibility and ratified and approved Pacific Forest Industries' action in delaying payment (R. 115-116).

F.

The Tax Court erred in failing to find that the credits from Pacific Forest Industries were not taxable income to the taxpayer, Harbor Plywood Corporation, until paid in cash. (Assignment of Error IX.)

The petitioner's primary contention is that the amounts represented by the credit memorandums were not income until actually paid in cash notwithstanding that the period of limitations on Renegotiation of Pacific Forest Industries expired prior to the dates of payment. This assertion is made because superimposed upon the threat of Renegotiation was the long delay in payment to Pacific Forest Industries by the Government on Lend-Lease contracts, which delay, in turn, delayed the payment by Pacific Forest Industries to its members (R. 116-117, 121-122; see also Exhibit 18-R (R. 100)). Therefore, until such funds had been received by Pacific Forest Industries, the petitioner, Harbor Plywood Corporation, had no right thereto. See *Weil v. Commissioner* (C.C.A. 2) 173 F.(2d) 805, affirming 5 T.C.M. 279.

G.

The Tax Court erred in failing to find, in the alternative, under the true rule of accrued income set forth above that when the credit memoranda were issued, the taxpayer had no fixed and unconditional right to the amount of each memorandum because at each such time

- (a) there was a contingency which might preclude ultimate payment, namely, the possible and probable renegotiation of Pacific Forest Industries;
- (b) No reasonable expectancy that the right would

be converted into money could exist so long as such unresolved and intervening legal right as was created by the Renegotiation Act itself was not barred by the statute of limitations; and

(c) There was a further contingency which precluded payment imposed by Pacific Forest Industries itself, namely, the fact that it notified the taxpayer in writing, as The Tax Court properly found for each year, that each credit memorandum was issued "subject to Renegotiation";

and therefore, the amounts represented by said credit memoranda could not be accrued as taxable income by the taxpayer, Harbor Plywood Corporation, until the statute of limitations barred the Renegotiation of Pacific Forest Industries' income. (Assignment of Error IX.)

H.

The Tax Court erred in making and entering its decision of April 25, 1950. (Assignment of Error VIII.)

In support of this, and by way of an end to this Argument, petitioner re-advances all arguments made in parts A through G of this Argument.

CONCLUSION

In conclusion the petitioner wishes to add, and request, that this Court turn back the clock to the dates in question as indicated on the various exhibits in the Record. The decisions made by Pacific Forest Industries and by the taxpayer as to the time and method of payment of the amounts represented by the credit memoranda and the method of reporting them as income were not conceived with any bad faith or with any *quasi* tax-evading motives. This was not merely a fancy device, conceived either with the blessing of unusual foresight or with the benefit of actual hindsight, to shift these items of income to more favorable tax years. The whole history of these Pacific Forest Industries memoranda, the repeated considerations given to the Renegotiation problem by Pacific Forest Industries' executive committee and by the petitioner as well as by the attorney for both parties, clearly indicates that a sincere, honest, intelligent and sensible business attitude was taken by Pacific Forest Industries and by the petitioner. Business judgment buttressed by sound legal and accounting advice given at an early date were the reasons for delay in payment and delay in reporting income. All considerations of the Renegotiation problem, the delays in collection from the Government, the problem of the statute of limitations on Renegotiability, the limitations attached to the issuance of each credit memorandum, and the decisions as to the reporting of income by the petitioner were first made in complete good faith in the war years at a time when it appeared to even the most optimistic observers that the

war, the Renegotiation of Government contracts, and the imposition of high corporate taxes would continue for several years more. The delay in petitioner's reporting these credits as income was not prompted by some subtle scheme to move these items ahead in the years where the tax benefit to the petitioner would be greater. That, thanks to the Atom Bomb, and other fortunate events of history, the war ended more quickly and excess profits taxes were repealed sooner than had been hoped for, were circumstances not foreseen by the petitioner or by Pacific Forest Industries or, it is submitted, by anyone else of intelligence, in the dark years of 1943 and 1944. That the petitioner's method of reporting these credits on a cash basis, or even the alternative method of reporting them as income one year after their issuance, namely, when the period of limitations had run on Renegotiations, should produce tax benefits to the petitioner, is fortuitous and coincidental; it was not premeditated, prophesied or even remotely hoped for when the first decisions were made in 1943 and 1944 as to the proper tax method of paying and reporting such items as income, and therefore, should not be taken into account in any way in determining the result of this case.

For the reasons hereinbefore stated, it is respectfully submitted that the errors and omissions of The Tax Court of the United States be corrected and that The Tax Court of the United States be directed to enter an order in this case at bar of either (1) "No deficiency"; or, in the alternative, (2) to compute the correct deficiencies, if any, for each of said years in question in

accordance with the decision of this Court that the amounts represented by the credit memoranda issued by Pacific Forest Industries to Harbor Plywood Corporation were taxable to Harbor Plywood Corporation and should have been accrued by it as taxable income in the years when the statute of limitations barred Renegotiation of Pacific Forest Industries, and not before.

Respectfully submitted,

WARREN A. DOOLITTLE
Attorney for Petitioner.

APPENDIX A

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code:

“SEC. 22. GROSS INCOME.

“(a) General Definition — ‘Gross income’ includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *”

* * *

“SEC. 41. GENERAL RULE.

“The net income shall be computed upon the basis of the taxpayer’s annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *”

“SEC. 42. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

“(a) General Rule—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. In the case of the death of a taxpayer there shall be included in computing net income for the taxable period in which falls the date of his death, amounts accrued up to the date of his death if not otherwise properly includible in respect of such period or a prior period. In the case of the death of a taxpayer whose net income is computed upon the basis of the accrual method of accounting, amounts (except amounts includible in computing a partner's net income under section 182) accrued only by reason of the death of the taxpayer shall not be included in computing net income for the period in which falls the date of the taxpayer's death.”

Regulations 111:

“Sec. 29.22(a)-1. What Included in Gross Income—Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. * * *”

* * *

“Sec. 29.22(a)-5. Gross Income from Business—In the case of a manufacturing, merchandising, or mining business, ‘gross income’ means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside

operations or sources. In determining the gross income subtractions should not be made for depreciation, depletion, selling expenses, or losses, or for items not ordinarily used in computing the cost of goods sold.”

* * *

“Sec. 29.41-1. Computation of Net Income—Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditure which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer’s income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See sections 29.42-1 to 29.43-3, inclusive.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.”

“Sec. 29.42-1. When Included in Gross Income—
(a) In general—Except as otherwise provided in section 42, gains, profits, and income are to be included in the gross income for the taxable year in which they are received by the taxpayer, unless

they are included as of a different period in accordance with the approved method of accounting followed by him. * * *

* * *

“Sec. 29.42-2. Income Not Reduced to Possession—Income which is credited to the account of or set apart for a taxpayer and which may be drawn upon by him at any time is subject to tax for the year during which so credited or set apart, although not then actually reduced to possession. To constitute receipt in such a case the income must be credited or set apart to the taxpayer without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and must be made available to him so that it may be drawn at any time, and its receipt brought within his own control and disposition. A book entry, if made, should indicate an absolute transfer from one account to another. If a corporation contingently credits its employees with bonus stock, but the stock is not available to such employees until some future date, the mere crediting on the books of the corporation does not constitute receipt.”

**In the United States Court of Appeals
for the Ninth Circuit**

HARBOR PLYWOOD CORPORATION, a Corporation,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

On Petition for Review of the Decision of the Tax Court
of the United States

BRIEF FOR THE RESPONDENT

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In the United States Court of Appeals for the Ninth Circuit

No. 12,660

HARBOR PLYWOOD CORPORATION, a Corporation,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

On Petition for Review of the Decision of the Tax Court
of the United States

BRIEF FOR THE RESPONDENT

OPINION BELOW

The opinion of the Tax Court (R. 124-133) is reported at 14 T. C. 158.

JURISDICTION

This petition for review (R. 140-147) involves federal excess profits tax liability for the years 1943 and 1944, and income tax liability for the year 1945. The Commissioner's notices of deficiencies were mailed to the taxpayer on July 23, 1948. (R. 12.) Within ninety

days thereafter, and on October 20, 1948, taxpayer filed its petition with the Tax Court for redetermination of the deficiencies, under the provisions of Section 272 of the Internal Revenue Code. (R. 4-15.) The decision of the Tax Court sustaining the deficiencies was entered April 25, 1950. (R. 139.) The case is brought to this Court by petition for review filed July 17, 1950 (R. 140-147), pursuant to the provisions of Section 1141(a) of the Internal Revenue Code, as amended by Section 36 of the Act of June 25, 1948.

QUESTION PRESENTED

Whether taxpayer, filing its returns on the "accrual" basis, may postpone reporting income earned by and credited to it in the taxable years until the years in which the income was actually collected, because of a possibility that the amounts credited might not be collected.

STATUTE AND REGULATIONS INVOLVED

These appear in the Appendix, *infra*.

STATEMENT

The facts as stipulated (R. 25-82) and found by the Tax Court (R. 125-129) may be summarized as follows:

Taxpayer-corporation, a manufacturer and distributor of plywood and other building materials, keeps its books and files its returns on the accrual and calendar year basis. (R. 125-126.) It is one of about twenty-five stockholder-members of Pacific Forest Industries (hereinafter called "Pacific"), a cooperative selling association organized for the purpose of exporting plywood and other forest products for its members, as authorized by the Webb Export Trade Act. Pacific's income consists of commissions on sales made on behalf

of its members, and it keeps its books on the basis of a fiscal year ending March 31st. Its by-laws provide that if the commissions received by it in any year exceed selling costs, the excess must (unless the board of trustees directs otherwise) be returned or credited to the members as an addition to the purchase price of the merchandise sold by them. (R. 51-52, 126-127.)

At the close of each of its fiscal years 1943, 1944, and 1945, Pacific issued to taxpayer a credit memorandum for amounts representing taxpayer's proportionate share of the excessive commissions which had been charged to the members on sales of their products during the year. These amounts were credited to taxpayer on the books of Pacific as of the dates the credit memoranda were issued, and were claimed and allowed as exclusions from Pacific's gross income in its tax returns for those years. (R. 33-35, 127.)

In issuing to taxpayer the credit memorandum of March 31, 1943, Pacific wrote taxpayer as follows (R. 127-128):

We are pleased to enclose Credit Memorandum to cover price adjustment on orders supplied by you and shipped by us during the period April 1st, 1942, through March 31st, 1943. * * *

May we point out, however, that the Treasury Department has filed with us a request for renegotiation of the contracts which we have accepted and are filling. It is, therefore, impossible to distribute the additional price evidenced by the enclosed Credit Memorandum until the results of the renegotiation are known. We believe, however, that the results will be favorable since, in the first place, we are a non-profit organization and secondly, all plywood which we have shipped has gone outside the Continental United States and thus the con-

tracts should not be subject to renegotiation under the law.

Each of the other credit memoranda for the fiscal years 1944 and 1945 was issued subject to the same restriction as to payment. (R. 128.)

Prior to issuing the credit memoranda to taxpayer, Pacific received a letter from the War Department Price Adjustment Board, requesting that it submit information on the basis of which the War Department could determine whether Pacific's contracts were entitled to clearance or subject to renegotiation. (R. 57-60.) Renewed requests for such information were sent in 1943 by the Treasury Department Price Adjustment Board. (R. 64-71.) In May of 1944, Pacific wrote its members that "A statement is being filed this month with the Price Adjustment Board of the Treasury Department which it is hoped will result in clearance." (R. 76-77.) In June of 1944 the Treasury Department Price Adjustment Board advised Pacific that upon review of the information submitted "no further action is contemplated." (R. 77-78.) Pacific at all times maintained that it was not subject to renegotiation and was finally sustained on that contention. (R. 128, 130.) The renegotiation of Pacific for its fiscal years ended 1943, 1944, and 1945 was barred by the running of the statute of limitations on March 31, 1944, May 11, 1945, and May 29, 1946, respectively. (R. 128.)

Pacific paid the 1943 credit memorandum in 1944. It paid the 1944 and 1945 credit memoranda in 1946. The delay in payment beyond the dates of expiration of the statute of limitations on renegotiation was due to the fact that Pacific had not collected for all of its sales and did not have sufficient cash on hand to make the payments sooner. (R. 128-129.)

Taxpayer reported the amounts credited to it in the years they were paid. The Commissioner determined that the amounts accrued and were taxable to taxpayer in the years when the credit memoranda were issued. (R. 129.) The Tax Court, one Judge dissenting, sustained the Commissioner's determination. (R. 129-133.)¹

SUMMARY OF ARGUMENT

It is settled that a taxpayer reporting on the "accrual" basis must accrue and report income in the taxable year in which his right to receive it becomes fixed, irrespective of whether or when it is eventually received, if there is a reasonable expectancy of its receipt. If the account receivable turns out to be uncollectible, the taxpayer may have a deduction in the year it becomes uncollectible, but the income accrues in the year the right to receive it arose. The record unquestionably warrants the Tax Court's conclusion that taxpayer's right to receive the income here involved arose in the taxable years (not in the years taxpayer received and reported it), and that there was a reasonable expectancy of its receipt. All the events fixing taxpayer's right to receive and the amounts receivable had occurred; indeed, taxpayer's debtor (Pacific) formally acknowledged the amounts to be owing by issuing credit memoranda to taxpayer. That Pacific delayed payment of the amounts credited pending determination of whether its profits were subject to renegotiation did not affect taxpayer's right to receive (and corre-

¹ It is stipulated that if the income in question is not taxable either in the years the credit memoranda were issued, as the Tax Court held, or in the years they were paid, as taxpayer contends, then they are taxable in the years when renegotiation of Pacific's income was barred by the statute of limitations; and the amount of the deficiencies in such event has also been stipulated (R. 29-30.)

sponding duty to accrue) the amounts credited, but only the prospects of collecting the full amounts receivable. Moreover, taxpayer had every reason to expect ultimate payment since, as the documentary exhibits show, and the Tax Court found, there existed nothing more than a bare possibility (which never materialized) of renegotiation of Pacific's contracts. That possibility no more justifies postponement of the year of accrual to the year of actual receipt than does any other possibility of non-collection of an account receivable. To tie the date of accrual to the date of actual receipt, merely because of a possibility that the income may not be collected, would in effect erase the basic difference between the "cash" and "accrual" systems of tax accounting. Even assuming that the amounts credited did not accrue until the years in which renegotiation of Pacific's profits was barred by the statute of limitations, taxpayer still cannot prevail, for it did not report the income in those years but in later years when it was actually received. Taxpayer's contention that there was no "constructive receipt" of the income in the taxable years is addressed to a straw issue; the doctrine of constructive receipt applies only to taxpayers reporting on the cash receipts and disbursements basis. Taxpayer points to no authority which warrants reversal of the decision below.

ARGUMENT

The Tax Court Correctly Held That the Income in Question Accrued in the Years Taxpayer's Right to Receive It Arose, Not in the Years It Was Received and Reported.

A. The applicable principles.

Code Section 21 (Appendix, *infra*) defines net income as the gross income less allowable deductions. Sections 41, 42, and 43 (Appendix, *infra*) require net income to be computed on the basis of annual account-

ing periods (calendar or fiscal year), in accordance with the method of accounting regularly employed by the taxpayer (cash or accrual), provided such method clearly reflects the net income for the taxable year. See also Code Section 48 (Appendix, *infra*); Sections 29.42-1 and 29.43-1 of Regulations 111 under the Code (Appendix, *infra*).

The two principal recognized accounting systems are the so-called "cash" and "accrual" methods. Under the "cash" method, income is reported in the year of actual receipt and deductions are taken in the year of actual expenditure. Under the "accrual" method, income is allocated to the year in which it is earned or realized, *i.e.*, when the *right* to receive it becomes fixed, even though it is not presently receivable and irrespective of the year of actual receipt. Conversely, deduction items are allocated to the year in which they are incurred, *i.e.*, when the *liability* to pay becomes fixed, even though payment is not presently due and irrespective of the year of actual payment. *Security Mills Co. v. Commissioner*, 321 U. S. 281; *Brown v. Helvering*, 291 U. S. 193; *Spring City Co. v. Commissioner*, 292 U. S. 182; *United States v. Anderson*, 269 U. S. 422; *Continental Tie & L. Co. v. United States*, 286 U. S. 290; 2 Mertens, *Law of Federal Income Taxation* (1942), Secs. 12.01, 12.07, 12.08. Whichever method is adopted must be applied consistently. The cardinal rule is that the net income must be computed on an annual basis according to the method selected, and neither income nor deduction items may be accelerated or postponed from one taxable year to another. As the Supreme Court stated in the *Security Mills* case (pp. 286-287):

The rationale of the system is this: "It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the

government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation.”

This legal principle has often been stated and applied. The uniform result has been denial both to Government and to taxpayer of the privilege of allocating income or outgo to a year other than the year of actual receipt or payment, *or applying the accrual basis, the year in which the right to receive, or the obligation to pay, has become final and definite in amount.* (Italics ours.)

The *right to receive* income, which is determinative of when it “accrues”, is not to be confused with the prospect of its collectibility. The right to receive may become fixed both in fact and amount, although collection of all or part of the amount receivable may be uncertain. The income accrues in the year when the right to receive it arises, irrespective of whether or when it is ultimately received, so long as there was a reasonable expectancy of payment. If the account receivable later turns out to be uncollectible in whole or in part, the taxpayer may have a deduction (*e.g.*, bad debt or loss) in the year in which the receivable becomes uncollectible, but the income must be reported when the right to receive it ripens. In the words of this Court in *H. Liebes & Co. v. Commissioner*, 90 F. 2d 932, 937-938:

So far, only the right to receive has been considered. Must we also consider the prospect of realization on that right by the taxpayer? In other words, when the right to receive arises, should the fact that the right is or is not collectible be taken into consideration in determining whether income has accrued? We believe that no income

accrues unless there is a reasonable expectancy that the right will be converted into money or its equivalent. * * *

The complete definition would therefore seem to be that income accrues to a taxpayer, when there arises to him a fixed or unconditional right to receive it, if there is a reasonable expectancy that the right will be converted into money or its equivalent.

In the leading case of *Spring City Co. v. Commissioner, supra*, a taxpayer on the accrual basis sold goods during 1920 on open account. The vendee went into bankruptcy in December of that year, and the taxpayer-vendor was thus prohibited from enforcing payment in that year. In 1922 and 1923 the receiver in bankruptcy declared and paid dividends to the vendee's creditors, including taxpayer. In its 1920 return taxpayer claimed the sale price of the goods as a deduction, and in its returns for 1922 and 1923 it reported as income the dividends received in those years. The Supreme Court held that (1) the entire sale price accrued as income in 1920, notwithstanding that taxpayer was prevented from receiving payment in that year; and (2) taxpayer was not entitled to a bad debt deduction in 1920, but in 1923 when the final dividend was paid and the balance of the price was ascertained to be uncollectible. The Supreme Court stated (pp. 184-185, 189):

Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the *right* to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues. When a merchandising concern makes sales, its

inventory is reduced and a claim for the purchase price arises. * * *

* * * If such accounts receivable become uncollectible, in whole or part, the question is one of the deduction which may be taken according to the applicable statute. * * *

* * *

Petitioner insists that "good business practice" forbade the inclusion in the taxpayer's assets of the account receivable in question or at least the part of it which was subsequently found to be uncollectible. But that is not the question here.

In *Continental Tie & L. Co. v. United States, supra*, the property of the taxpayer, a railroad company, was taken over and operated by the Federal Government during the first world war. Upon passage of the Transportation Act of 1920 it became entitled to an award by the Interstate Commerce Commission in an amount to be calculated as prescribed in that Act. It was not until 1923, however, that the Commission made an award and paid the amount to taxpayer. The Supreme Court held that the income accrued in 1920, not in the year the award was made and paid, stating (pp. 294-297):

The petitioner kept its accounts upon the accrual basis. The government insists, and the Court of Claims held, that the right to payment having ripened in 1920, the taxpayer should have returned the estimated award under section 204 as income for that year. The petitioner replies that a determination whether it would receive any award under the section and, if so, the amount of it, depended on so many contingencies that no reasonable estimate could have been made in 1920, and

that the sum ultimately ascertained should be deemed income for 1923, the year of the award and payment.

* * * Petitioner's right to payment ripened when the act became law. What sum of money that right represented is, of course, a different matter.

The petitioner says that at the date of the passage of the act it was impossible to predict that any award would be made to the railway, and, assuming one would eventuate, its amount could not be estimated, for the reason that the principles upon which awards were to be made had to be settled by the Commission and were not finally formulated until 1923. * * *

* * *

* * * But in spite of these inherent difficulties we think it was possible for a carrier to ascertain with reasonable accuracy the amount of the award to be paid by the Government.

In *Franklin County Distilling Co. v. Commissioner*, 125 F. 2d 800 (C. A. 10th), the taxpayer sold whisky in 1935 under contracts which provided that whenever the buyers chose to withdraw the whisky from the warehouse they were to reimburse taxpayer for the whisky-production tax and storage charges. The taxpayer contended that the promised amounts did not represent accrued income in 1935 because they were neither payable nor ascertainable in that year. The court held that the right to receive the income became fixed in 1935 and hence that the income accrued in that year. It stated (pp. 803-804):

Where income tax returns are made by the taxpayer on an accrual basis, there need not be certainty, but only reasonable accuracy, in calculating

an amount to be received, in order to bring that amount within taxable income. *Continental Tie & Lumber Co. v. United States*, 286 U. S. 290, 296, 297, 52 S. Ct. 529, 76 L. Ed. 1111.

Whether a taxpayer is entitled to or bound to accrue an item of income in a certain year depends upon whether there was justification for a reasonable expectation that payment of the item would be made in due course. * * *

* * *

When accounts are kept on an accrual basis, income must be accounted for in the year in which realized, although not then actually received; and deductions should be taken in the year in which the deductible items are incurred.

In *Automobile Ins. Co. v. Commissioner*, 72 F. 2d 265 (C. A. 2d), the taxpayer received an award by the German Mixed Claims Commission in 1928, payable over a number of years. The court held that the total amount of the award accrued as income in 1928 because (p. 268)—

The petitioner's right to receive the amount of its award became fixed in 1928, and there then existed reasonable ground to believe that it would ultimately be paid.

In *Barker v. Magruder*, 95 F. 2d 122 (C. A. D. C.), it was held that uncollected usurious interest was accruable as income, notwithstanding that the taxpayer had no legal right to enforce collection, since there was a reasonable expectation that interest would be paid. The court stated (p. 125) that—

though the accruals represented legally uncollectible usury, there was at all times a reasonable ex-

pectation that they would be paid, and this fact is enough to constitute them income to the same extent as if the several amounts were actually paid.

In *Clark v. Woodward Construction Co.*, 179 F. 2d 176 (C. A. 10th), the taxpayer completed work under a state highway construction contract in 1942, but under the state law was precluded from receiving final payment until expiration of a statutory notice to subcontractors who might have claims against the taxpayer. The court held that the taxpayer's right to receive payment arose, and hence the income accrued, in the year the work was completed, notwithstanding that the income was not collectible in that year and that the fund available for payment was impounded. The court stated (p. 177):

Where a taxpayer keeps his books and makes his tax returns on the accrual basis, income accrues when all events have accrued from which liability is determined and the liability has become fixed even though payment is deferred to a time in a subsequent year.

See also *Lichtenberger-Ferguson Co. v. Welch*, 54 F. 2d 570 (C. A. 9th); *Brunton v. Commissioner*, 42 F. 2d 81 (C. A. 9th); *United States v. Amalgamated Sugar Co.*, 72 F. 2d 755 (C. A. 10th); *Frost Lumber Industries v. Commissioner*, 128 F. 2d 693 (C. A. 5th); *Clifton Mfg. Co. v. Commissioner*, 137 F. 2d 290 (C. A. 4th); *Helvering v. Russian Finance & Construction Corp.*, 77 F. 2d 324 (C. A. 2d); *Peyton Du-Pont Securities Co. v. Commissioner*, 66 F. 2d 718 (C. A. 2d); *Commissioner v. Brooklyn Union Gas Co.*, 62 F. 2d 505 (C. A. 2d); *American Cigar Co. v. Commissioner*, 66 F. 2d 425 (C. A. 2d), certiorari denied, 290 U. S. 699;

Georgia School-Book Depository, Inc. v. Commissioner, 1 T. C. 463.

Taxpayer misconceives the controlling principles in contending (Br. 9-10) that it had no fixed right to receive the amounts credited to it by Pacific because "there was a contingency which might preclude ultimate payment, namely, the possible Renegotiation" of Pacific's profits. The basic fallacy in taxpayer's reasoning lies in its failure to distinguish between the right to receive income and the prospect of its eventual receipt. Income "accrues" when the right to receive it becomes definite, if there is a reasonable expectancy of its receipt. An accrual basis taxpayer who earns income, and in fact (as here) is credited by his debtor with the amount earned, is not excused from accruing and reporting the income merely because of a possibility that his debtor may thereafter become unable or unwilling to pay it.² That income earned and accrued may not be ultimately collected is a contingency which confronts every accrual basis taxpayer; the debtor might become financially unable to pay because of insolvency or (as here) because his income might be renegotiated. But uncertainty as to the collectibility of income is not tantamount to a condition precedent to the right to receive it. So long as there is a reasonable expectancy of payment it is immaterial that collection may be prevented or postponed by operation of law (e.g., *Spring City Co. v. Commissioner, supra*; *Clark v. Woodward Construction Co., supra*), or by agreement of the parties (e.g., *Franklin County Distilling Co. v. Commissioner, supra*; *United States v. Amal-*

² If income accrued and reported in one year becomes uncollectible in whole or in part in a later year, the taxpayer may have a bad debt deduction in the later year. Code Section 23(k); Section 29.23(k)-2 of Regulations 111. See *Spring City Co. v. Commissioner, supra*.

gamated Sugar Co., supra), or by difficulties in ascertaining the amount receivable (*e.g., Continental Tie & L. Co. v. United States, supra; Automobile Ins. Co. v. Commissioner, supra*), or, for that matter, that collection is not legally enforceable at all (*e.g., Barker v. Magruder, supra*). To hold otherwise would in effect tie the year of accrual to the year of actual receipt, and erase the essential difference between the cash and accrual systems of tax accounting. What is more, it would violate the fundamental rule that items of income and deductions must be accounted for on an annual basis, regardless of the method of accounting used.

B. The record amply supports the Tax Court's conclusion.

As is plain from its opinion, the Tax Court followed the settled principles governing tax accounting on the accrual basis. Quoting from this Court's definition in the *Liebes* case, *supra*, it observed that (R. 130)—

income accrues to taxpayer, when there arises to him a fixed or unconditional right to receive it, if there is a reasonable expectancy that the right will be converted into money or its equivalent.

Applying that rule, it concluded that the income in question accrued and was taxable to taxpayer in the years (1943-1945) when taxpayer's right to receive it became fixed, not in the years it was actually received and reported by taxpayer. (R. 130-131.) We submit that, far from being clearly erroneous as taxpayer contends, the Tax Court's conclusion is fully supported by the record. The undisputed facts show that no contingency existed as to taxpayer's right to receive the income, and that there was a reasonable expectancy of its payment.

1. *The right to receive the income arose in the taxable years.*

The facts dispositive of this case have been stipulated. Taxpayer sold merchandise through Pacific, a cooperative selling association of which it was a stockholder-member, under an arrangement whereby Pacific charged its members selling commissions. Pacific's by-laws obligated it at the end of each year to "return or credit" to the members proportionate shares of the excess of the commissions charged over selling expenses "as an addition to the purchase price of the merchandise sold by them". (R. 51-52, 126.) In compliance with that obligation and during each of the taxable years, Pacific issued to taxpayer a credit memorandum for a specified amount, representing taxpayer's pro rata share of excessive commissions. (R. 33-35, 127.) Thus all the events fixing taxpayer's right to receive the income, as well as the exact amounts receivable, occurred in the taxable years. Taxpayer's merchandise had been sold and delivered, and the amounts owing to it by Pacific "as an addition to the purchase price" were specified. If any doubt otherwise existed as to whether taxpayer's right to receive the amounts arose in the taxable years, it is dispelled by the undisputed fact that Pacific formally acknowledged the amounts to be owing in those years by issuing credit memoranda to taxpayer.

Moreover, Pacific credited the amounts to taxpayer on its books during the taxable years, and in its tax returns covering those years claimed and was allowed the amounts as exclusions from its own income. (R. 127, 130.) To be sure, as taxpayer insists (Br. 41-43), Pacific was an independent taxable entity, separate and distinct from taxpayer. But it does not follow (as taxpayer assumes) that the year in which Pacific

treated the amounts as owing to taxpayer has no bearing on the year in which taxpayer's right to receive them arose. On the contrary, that Pacific on its books and in its returns regarded itself indebted to taxpayer in the taxable years for the amounts in question serves to confirm the Tax Court's conclusion that taxpayer's right to receive the amounts arose in those years, not in some later year.

Since Pacific was required to return or credit the amounts in question to taxpayer "as an addition to the purchase price of the merchandise sold" by taxpayer through Pacific (R. 52, 126), taxpayer's position for tax purposes is essentially the same as that of any other accrual basis taxpayer who acquires an account receivable for merchandise sold and delivered. Like any other seller reporting on the accrual basis, it must accrue the purchase price when its right to receive it arises, not when its collectibility becomes certain. *Spring City Co. v. Commissioner, supra*; *Clark v. Woodward Construction Co., supra*; *United States v. Amalgamated Sugar Co., supra*. On taxpayer's theory, an accrual basis taxpayer whose debtor's profits may be renegotiated could postpone accrual of accounts receivable from that debtor until actual payment. To subscribe to such theory would render indistinguishable the accrual and the cash methods of tax accounting. Even if taxpayer itself were subject to renegotiation (and its income for the taxable years here involved had actually been renegotiated), that would not have relieved it of the duty to accrue and report the income in the first instance.³ *A fortiori*, the possibility of re-

³ Section 3806 of the Internal Revenue Code, dealing with "Mitigation of Effect of Renegotiation of War Contracts", prescribes an exclusive remedy available to taxpayers whose contracts are renegotiated. It provides that if the taxpayer is required to repay excessive profits upon a renegotiation, the amount repayable shall be

negotiation of Pacific—admittedly an independent taxpayer (Br. 41-43)—did not have that effect.

2. *There was a reasonable expectancy of payment of the amounts receivable.*

If there was a reasonable expectancy that Pacific would eventually pay the amounts which it credited to taxpayer, then under the controlling decisions taxpayer was bound to accrue and report the amounts in the taxable years, when its right to receive them became fixed. It was not justified in postponing accrual to the years of actual payment.

Taxpayer takes the position (Br. 33-39), adopted by the lone dissenting Judge below (R. 132-133), that there was no reasonable expectancy of payment of the amounts receivable because it was “highly probable” that Pacific’s contracts would be renegotiated. The contention is without merit. The documentary exhibits show (R. 57-82), as the Tax Court pointed out (R. 130), that there was nothing more than a “mere possibility” (which never materialized) of renegotiation of Pacific’s contracts. There was not only a “reasonable expectancy” (*H. Liebes & Co. v. Commissioner, supra*, p. 938) that Pacific would pay the amounts it credited to taxpayer, but every expectancy that it would do so.

Pacific credited the amounts in question to taxpayer, and offset them against its own income, notwithstanding its receipt of a letter from the War Department

treated as a reduction of the contract price for the prior taxable year in which the price was “received or accrued”, and that any resulting decrease in the tax for such prior year shall be offset against the excess profits repayable. Thus a taxpayer whose contracts are subject to renegotiation must report the contract price according to his regular method of accounting (cash or accrual) and if the contracts are later renegotiated he is entitled only to the offset relief allowed in Section 3806.

Price Adjustment Board requesting information from which that board could determine whether Pacific's contracts were subject to renegotiation. (R. 57-60.) This letter, dated December 18, 1942, stated that, pursuant to Section 403 of the Sixth Supplemental National Defense Act of 1942 as amended, Price Adjustment Boards had been established by the War, Navy, and Treasury Departments, whose function it was to conduct renegotiation proceedings with parties to contracts made with those departments; that "the objective of such proceedings is to lead to a clearance of the companies" under the Act; that "we will be glad to receive any information which you may care to submit bearing upon the matter"; and that "Such information will in any case be received without prejudice to you". (R. 58-60.) A questionnaire form to be filled out by Pacific was enclosed with this letter. (R. 61-62.) Pacific declined to furnish the requested information, claiming that it was not subject to renegotiations because it was a cooperative association exempt from income tax. (R. 65.)⁴ Renewed requests for the information were then sent by the Treasury Department Price Adjustment Board. (R. 65-66, 70-71.) In May of 1944 Pacific wrote its stockholders (including taxpayer) that "A statement is being filed this month with the Price Adjustment Board of the Treasury Department which it is hoped will result in clearance."

⁴ It is well settled that cooperative associations, such as Pacific, engaged exclusively in selling the products of its stockholder-members on a commission basis, are not taxable on income which, pursuant to their charters or by-laws, they are required to return to the stockholders each year as rebates or patronage dividends. *San Joaquin Valley Poultry Producers' Assn. v. Commissioner*, 136 F. 2d 382 (C. A. 9th). It has been so held as to Pacific itself. *Pacific Forest Industries v. Commissioner*, decided November 4, 1941 (1941 P-H B. T. A. Memorandum Decisions, par. 41,490).

(R. 76-77.) And in a letter accompanying each of the three credit memoranda issued to taxpayer Pacific stated that it would not “distribute” the amounts credited until it learned whether it was subject to renegotiation, but that it believed “the results will be favorable” because it was a non-profit organization and “should not be subject to renegotiation under the law.”

(R. 62-63, 128.) In June of 1944, long before the third credit memorandum was issued, the Price Adjustment Board wrote Pacific that upon review of the information submitted “no further action is contemplated.”

(R. 77-78.) Thereafter the amounts credited to taxpayer were paid in full by Pacific (R. 128), and taxpayer reported the amounts as income in the years they were paid (R. 129).⁵

These documentary facts unquestionably warrant the Tax Court's conclusion (R. 130) that there existed only a “possibility of renegotiation” of Pacific's income when the credit memoranda were issued to taxpayer, and that there was a reasonable expectancy of payment of the amounts credited. The burden of proving that the amounts receivable were uncollectible rested of course upon taxpayer, and it clearly failed to meet that burden. The undisputed facts that (1) Pacific at all times insisted that it was not subject to renegotiation and was sustained in that contention (R. 128, 130), and (2) issued the credit memoranda to taxpayer even after the question of renegotiation was

⁵ If, as taxpayer claims, the amounts credited to it by Pacific were not accruable because Pacific's profits might be subject to renegotiation, then it should have reported the amounts in the years renegotiation of Pacific was barred by the statute of limitations and no longer a possibility. This taxpayer did not do. Instead, it reported the amounts in later years, when it actually received payment. (R. 128-129.)

raised and subsequently paid the full amounts credited, in and of themselves amply support the decision below.

Taxpayer does not and cannot point to anything in the record to support its view that there was no reasonable expectancy of payment of the amounts credited (and actually paid) to it by Pacific. Its characterization of the letters received by Pacific from the Price Adjustment Board as "threats to renegotiate" (Br. 33) is unjustified. As is evident from the contents of the letters the Board was repeatedly requesting *information*, which Pacific had failed to supply, on the basis of which it could be determined whether Pacific's contracts were subject to renegotiation under the renegotiation statute. (R. 57-62, 65-71.) After Pacific finally supplied the requested information, it was advised by the Board that "no further action is contemplated." (R. 78.) The most that could be said in taxpayer's favor is that conflicting inferences might be drawn as to whether it could reasonably expect payment of the amounts credited to it by Pacific. Certainly it cannot be said that the Tax Court's inference was clearly erroneous.

3. The cases relied upon by taxpayer furnish no basis for reversal.

Nor does taxpayer point to any authority which calls for reversal of the decision below. The decisions upon which it chiefly relies (Br. 22-31) are those of the Tax Court, the very tribunal whose decision it here attacks. Each case in this field turns, as it must, on its own facts. Moreover, the only Tax Court case discussed by taxpayer (Br. 22-24) which bears a factual resemblance to this one is *Georgia School-Book Depository, Inc. v. Commissioner*, 1 T. C. 463, and the Tax Court's decision there is in complete accord with its decision here. At any rate, even granting that the Tax Court's decision

in this case is inconsistent with its decisions in other cases, that would still furnish no authority for reversal here, for other things being equal "one decision of the Board is entitled to as much weight as another." *Rogers v. Commissioner*, 103 F. 2d 790, 793 (C. A. 9th), certiorari denied, 308 U. S. 580. See also *Louisville Property Co. v. Commissioner*, 140 F. 2d 547, 549 (C. A. 6th), certiorari denied, 322 U. S. 755.

As for the *Liebes* case, upon which taxpayer heavily relies (Br. 11-22), the Tax Court here applied the very principles there enunciated to the undisputed facts of this case. (R. 129-130.) This Court there affirmed the Tax Court's decision that an accrual basis taxpayer which sued the Government for damages and recovered a judgment, could not accrue the amount of the judgment until the time for appeal by the Government had expired. Affirmance of the Tax Court's decision was clearly correct, since the taxpayer's claim to the income was contested and being litigated, and until the time to appeal from the judgment expired it could not be said that the taxpayer's right to receive the income had become fixed. No such situation is here presented, and there is no basis for taxpayer's attempt (Br. 21) to analogize the two cases. Taxpayer here did not have a claim which was being disputed or litigated, as did the taxpayer in the *Liebes* case. It had a claim against Pacific which Pacific *acknowledged* to be due by issuing credit memoranda to taxpayer. True, there was a possibility that Pacific's income might be renegotiated, in which event the amounts receivable might become uncollectible, but that in no way detracts from the crucial fact that taxpayer's *right* to receive the amounts in question arose in the taxable years they were credited to it and that it had reasonable expectancy of ultimate payment. Besides, taxpayer here did not report the

income in the years when renegotiation of Pacific's income was barred, as it should have done if (as it claims) the *Liebes* case is analogous. It reported the income in the years of actual receipt. (R. 128-129.)

4. *The doctrine of "constructive receipt" is inapplicable.*

Taxpayer's contention (Br. 28-31, 41-43) that there was no "constructive receipt" in the taxable years of the amounts credited to it by Pacific is beside the issue. The doctrine of constructive receipt applies only to taxpayers who report their income on the cash receipts and disbursements method, not to those reporting on the "accrual" method. See 2 Mertens, Law of Federal Income Taxation (1942), Secs. 10.01, 10.02. The Commissioner had not contended, nor did the Tax Court hold, that taxpayer constructively received the income in question in the taxable years. As the Tax Court stated (R. 131):

The question of constructive receipt is not involved. It might have been had the petitioner reported on a cash basis rather than an accrual basis.

Accordingly, the cases relied upon by taxpayer (Br. 28-31, 42) involving the question of "constructive receipt" of income by taxpayers reporting on the cash basis are patently inapposite here.

C. In no event did the income accrue in the years taxpayer reported it.

Even assuming *arguendo* that the income receivable from Pacific accrued to taxpayer in the years that renegotiation of Pacific's income was barred by the statute of limitations, taxpayer still cannot prevail. It did not report the income in those years, but in the years it actually received payment from Pacific. (R. 128-

129.)⁶ Accordingly, even if this Court should reverse the Tax Court's decision that the income accrued in the years the credit memoranda were issued, deficiencies in tax are owing by taxpayer for the taxable years in amounts which have been stipulated by the parties. (R. 29-30.)

CONCLUSION

The decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

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Attorney General.*

DECEMBER, 1950.

⁶ Taxpayer in its brief has apparently abandoned its primary contention below that the income accrued in the years it was reported and now takes the position (Br. 9-10, 21-22), alternatively contended below, that it should have reported the income in the years renegotiation of Pacific's income became barred by the statute of limitations. The deficiencies to be entered in the event this alternative contention is sustained have been stipulated by the parties. (R. 29-30.)

APPENDIX

Internal Revenue Code:

SEC. 21. NET INCOME.

(a) *Definition*.—"Net income" means the gross income computed under section 22, less deductions allowed by Section 23.

* * *

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *

* * *

(26 U. S. C. 1946 ed., Sec. 41.)

SEC. 42 [As amended by Sec. 114, Revenue Act of 1941, c. 412, 55 Stat. 687]. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) *General rule*.—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period.

* * *

* * *

(26 U. S. C. 1946 ed., Sec. 42.)

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *

(26 U. S. C. 1946 ed., Sec. 43.)

SEC. 48. DEFINITIONS.

When used in this title—

(a) *Taxable year*.—"Taxable year" means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the net income is computed under this Part. * * *

* * *

(c) "*Paid, Incurred, Accrued*".—The terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under this Part.

* * *

(26 U. S. C. 1946 ed., Sec. 48.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

Sec. 29.42-1. *When Included in Gross Income*.—(a) *In General*.—Except as otherwise provided in section 42, gains, profits, and income are to be included in the

gross income for the taxable year in which they are received by the taxpayer, unless they are included as of a different period in accordance with the approved method of accounting followed by him. (See sections 29.41-1 to 29.41-3, inclusive.) * * * If no determination of compensation is had until the completion of the services, the amount received is ordinarily income for the taxable year of its determination, if the return is rendered on the accrual basis; or, for the taxable year in which received, if the return is rendered on the receipts and disbursements basis. * * * Such items as claims for compensation under canceled Government contracts constitute income for the year in which they are allowed or their value is otherwise definitely determined, if the return is rendered on the accrual basis; or for the year in which received, if the return is rendered on the basis of cash receipts and disbursements.

* * *

Sec. 29.43-1. "*Paid or Incurred*" and "*Paid or Accrued*."—(a) The terms "paid or incurred" and "paid or accrued" will be construed according to the method of accounting upon the basis of which the net income is computed by the taxpayer. (See section 48(c).) The deductions and credits provided for in chapter 1 (other than the dividends paid credit provided in section 27) must be taken for the taxable year in which "paid or accrued" or "paid or incurred," unless in order clearly to reflect the income such deductions or credits should be taken as of a different period. If a taxpayer desires to claim a deduction or a credit as of a period other than the period in which it was "paid or accrued" or "paid or incurred," he shall attach to his return a statement setting forth his request for consideration of the case by the Commissioner together with a complete statement of the facts upon which he relies. However,

in his income tax return he shall take the deduction or credit only for the taxable period in which it was actually "paid or incurred," or "paid or accrued," as the case may be. Upon the audit of the return, the Commissioner will decide whether the case is within the exception provided by the Internal Revenue Code, and the taxpayer will be advised as to the period for which the deduction or credit is properly allowable.

* * *

**In The United States Court of Appeals
For the Ninth Circuit**

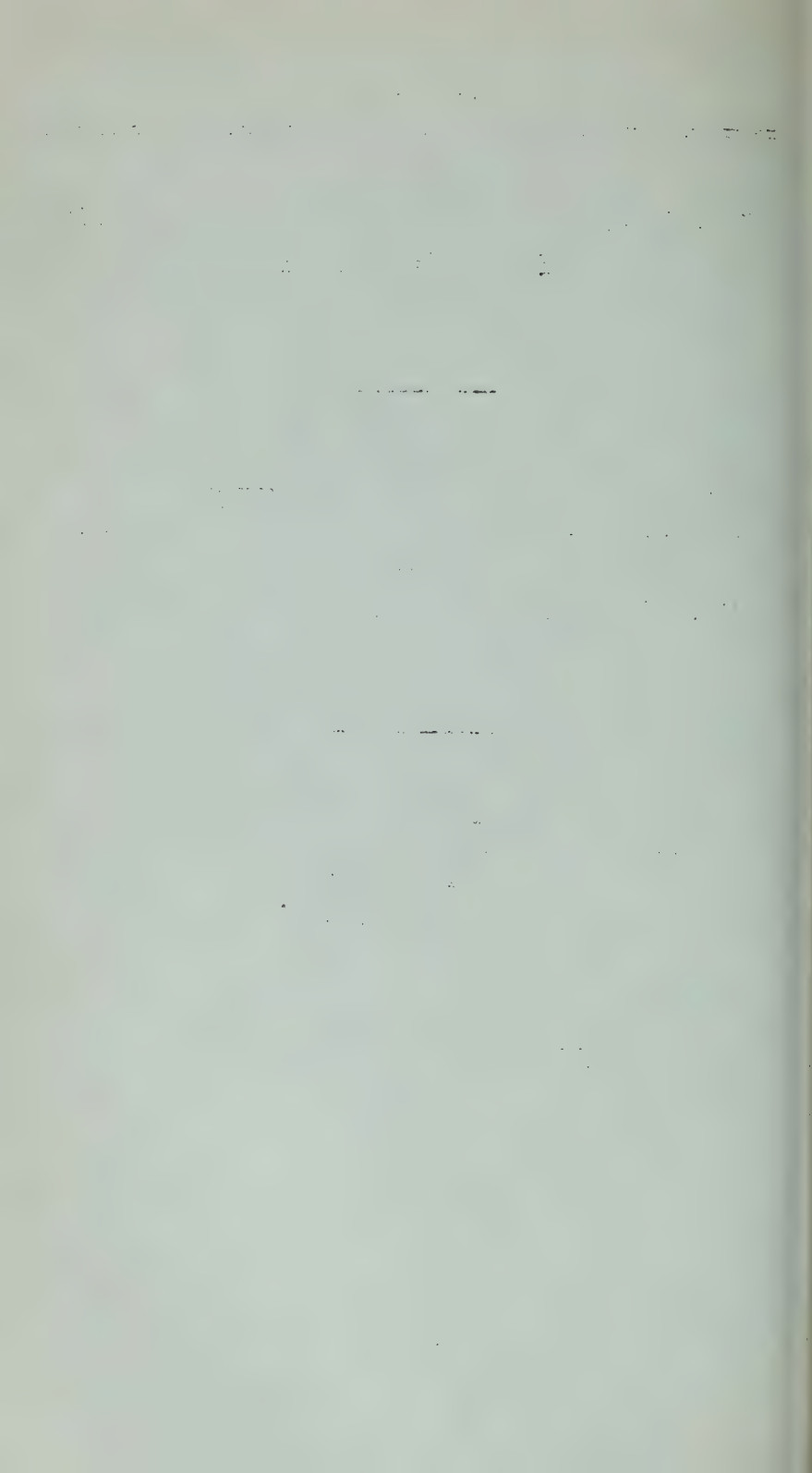
HARBOR PLYWOOD CORPORATION,
a Corporation, *Petitioner,*
vs
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

**UPON PETITION TO REVIEW A DECISION OF
THE TAX COURT OF THE
UNITED STATES**

REPLY BRIEF OF PETITIONER

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**In The United States Court of Appeals
For the Ninth Circuit**

HARBOR PLYWOOD CORPORATION,
a Corporation, *Petitioner,*

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

No. 12660

UPON PETITION TO REVIEW A DECISION OF
THE TAX COURT OF THE
UNITED STATES

REPLY BRIEF OF PETITIONER

I.

**OBJECTIONS TO RESPONDENT'S STATEMENT
OF THE CASE**

In two particulars the respondent's statement of the case on p. 4 of his brief is wholly inadequate. First, with reference to Joint Exhibit 7-G (R. 64-71) the respondent refers to this simply as a renewed request by the Treasury Department Price Adjustment Board for information to determine if Pacific's contracts were entitled to clearance or were subject to renegotiation. This was no mere request. It was no form letter. It was a positive statement that Pacific was *not* exempt from renegotiation and that it was subject to renegotiation. Paragraph Two of that letter from the Chairman of

the Price Adjustment Board concluded with an unequivocal directive in these words:

“Consequently, I am directed to require that your accounts be renegotiated.” (R. 65.) (Also see pp. 33-34 of Petitioner’s brief).

The second inadequacy in respondent’s statement is found in respondent’s reference to Joint Exhibit 11-K (R. 77-78). It is true that in this letter to Pacific the Price Adjustment Board stated, in part, that upon review of the information submitted “no further action is contemplated.” However, this letter contained two distinct limitations. First, it was limited to the fiscal year ending March 31, 1944 (not 1943 as stated in error—see Joint Exhibit 12-L and 13-M, (R. 79-80); second, it expressly stated that “ * * * such cancellation does not operate as a release of liability under the Renegotiation Statute * * * ” (R. 78). Therefore, the Tax Court’s finding (R. 128, 130), repeated by respondent in its brief at p. 4, that Pacific was sustained in its contention that it was not subject to renegotiation is inaccurate. In short, Joint Exhibit 11-K was not an unconditional clearance for Pacific. By its own terms, no unconditional clearance took effect until the Renegotiation was barred by the statute of limitations. Until this happened, Harbor Plywood had no enforceable claim against Pacific Forest Industries and, hence, no accrued income.

II.

REPLY TO RESPONDENT'S ARGUMENT

A. The Applicable Principles Laid Down by this Court in the *Liebes* Case, Which Remain Unchanged, Support the Taxpayer's Alternative Contention.

The petitioner does not disagree with the respondent's statement (Br. 8) that the right to receive may become fixed both in fact and in amount, although collection of all or part of the amount receivable may be uncertain. So, too, petitioner agrees that future uncollectibility of a fixed amount receivable may give rise to a bad debt deduction at such future time. But does not all of this presuppose that the *amount* of the income which the taxpayer has a right to receive is either fixed and definite or is at least susceptible of ascertainment with reasonable accuracy? The language of the leading case of *Spring City Co. v. Commissioner*, 292 U.S. 182, refers to an "amount" when it says (pp. 184):

" * * * that it is the right to receive and not the actual receipt that determines the inclusion of the *amount* in gross income. When the right to receive an *amount* becomes fixed, the right accrues." (Italics supplied).

This is certainly language relating not only to an enforceable right but also to a determinable amount.

Both parties agree, by their citation of the language in the *Spring City* case, *supra*, and their citation of this Court's language in the case of *H. Leibes & Co. v. Commissioner*, 90 F.(2d) 932, 937-938, that income accrues when the right to receive an amount becomes fixed if there is a reasonable expectancy that the right will be

converted into money or its equivalent. This being so, it will be seen that it is the Commissioner, and not the taxpayer, who is fallacious in his reasoning.

Substantially all of the cases cited by respondent in part A of his argument (Br. 6-15) were decided before, and were considered and cited by this Court in, the *Liebes* case, *supra*, and appear in that part of the *Liebes* opinion quoted extensively by Petitioner in its brief, pages 14-20. No new cases have changed the rule of the *Liebes* case.¹ Those cases cited and relied upon so enthusiastically by respondent dealt with *amounts* which were either definite (*e.g.*, *Spring City v. Commissioner*, *supra*; *Clark v. Woodward Construction* (C.A. 10th) 179 F.(2d) 176, or susceptible of ascertainment with reasonable accuracy (*e.g.*, *Continental Tie & Lumber*

¹ Since the *Liebes* case was decided in 1937 there have been no new decisions of this Court, of other Circuit Courts of Appeal or of the United States Supreme Court altering the fundamental principles laid down in the *Liebes* case. The principal cases of the higher courts on this subject since 1937 are: *Commissioner v. Lyon*, 97 F.(2d) 70 (C.A. 9th, 1938) involving a lease deposit which might be returnable by the lessor-taxpayer if the lease was terminated otherwise than by default of the lessee, where this Court held the deposit was income in the year of receipt because received without restriction as to its disposition even though taxpayer might be adjudged liable to restore its equivalent; *Franklin County Distilling Co. v. Commissioner*, 125 F.(2d) 800 (C.A. 6th, 1942), concerned with a fixed right to an amount which could be calculated with reasonable accuracy; *Security Mills Co. v. Commissioner*, 321 U.S. 281 (1944), concerned with the propriety of an accrued deduction, rather than accrued income; *Clark v. Woodward Construction Co.*, 179 F.(2d) 176 (C.A. 10th, 1950), discussed hereinafter and emphasize

Co. v. United States, 286 U.S. 290; *Automobile Insurance Co. v. Commissioner*, 72 F.(2d) 265 (C.A. 2d); *Franklin County Distilling Co. v. Commissioner*, 125 F.(2d) 800 (C.A. 6th).² When the right to receive such an amount became fixed or unconditional, and if there was a reasonable expectancy that such right would be converted into money or its equivalent, it should be accrued, *H. Liebes v. Commissioner, supra*.

² We are not concerned here at all with those cases where income has been received under a claim of right and without restriction as to its disposition, even though it may still be claimed that the taxpayer is not entitled to retain the money, and even though he may be adjudged liable to restore its equivalent, *North American Oil Consolidated v. Burnet*, (1932) 286 U.S. 417; *Brown v. Helvering*, (1934) 291 U.S. 193; *Commissioner v. Lyon*, (C.A. 9th, 1938) 97 F.(2d) 70, discussed *supra*, footnote No. 1; *Security Mills Co. v. Commissioner*, (1944) 321 U.S. 281; 154 A.L.R. 1276 and cases noted there.

ing that the decisive factor in accruing income is the creation of an enforceable liability; *Commissioner v. Edwards Drilling*, 95 F.(2d) 719 (C.A. 8th, 1938), emphasizing that, though under accrual method of accounting items must be accrued as income when events occur to fix amounts due and determine liability, strained construction in administrative efforts to accrue income should be avoided, and that a taxpayer is under no obligation to accrue income that he may never receive; *Broderick v. Anderson*, 23 F.Supp. 488 (D.C., S.D., N.Y., 1938) citing the "reasonable expectation" rule of the *Liebes* case; *Craig v. Thompson*, 177 F.(2d) 457 (C.A. 8th, 1949) reiterating that the right to receive the income must be fixed and definite and the amount thereof must be reasonably determinable; *Clifton Manufacturing Co. v. Commissioner*, 137 F.(2d) 290 (C.A. 4th, 1943) citing and re-emphasizing the sec-

But if the *amount* is not even susceptible of ascertainment with reasonable accuracy, what can be accrued? Nothing. The Commissioner seems to argue that if you have a definite and ascertainable right to an indefinite and *unascertainable* amount you have something to accrue.³ The Tax Court itself (R. 130) attempted without success to escape this dilemma, as Petitioner pointed out in its brief, pp. 36-37. When the Tax Court said:

“ * * * There was no contingency as to the amount of income represented by the credit memorandums or of Pacific’s right to receive it; *nor was there any contingency as to petitioner’s right to whatever income might remain after renegotiation, should that occur.* The mere possibility of renegotiation did not give rise to a liability which either Pacific or the petitioner could have accrued on its books, since it had not become fixed and was being

³ If this is not his argument, then he presumes what is not in the record, namely, that the *amount* represented by each credit memorandum when issued “subject to renegotiation” was susceptible of ascertainment with reasonable accuracy before the period of limitations expired on renegotiation. See Argument B-1 hereinafter.

ond half of the *Liebes* rule of reasonable expectancy of collection; *Swastika Oil & Gas Co. v. Commissioner*, 123 F.(2d) 382 (C.A. 6th, 1941) citing the *Liebes* case and relying on its rule that no income accrues unless there is a reasonable expectancy that the right will be converted into money or its equivalent; *Frost Lumber Industries v. Commissioner*, 128 F.(2d) 693 (C.A. 5th, 1942), (1) an item “accrues” when all events have occurred necessary to fix the liability of the parties and to determine the *amount* of such liabilities; (2) “Though the computation may be undetermined, if the

strenuously protested by Pacific. No liability for renegotiation was set up in Pacific's books. *Conceding that there was a possibility of renegotiation, there was no way of even approximating the amount of excessive profits that might be claimed by the Government.*" (Italics supplied).

it frankly admitted that Harbor Plywood could not ascertain with reasonable accuracy the *amount* it would receive under these conditional credit memos at the time of their issuance and, hence, could not come under the rule of *Continental Tie & Lumber Co. v. United States*, *supra*. Neither the taxpayer, Harbor Plywood, nor Pacific had in its books of account all of the data from which the *quantum* of the credit could be calculated within reasonable limits. Treasury's Price Adjustment Board here had no mere ministerial task as did the Interstate Commerce Commission in the *Continental Tie* case, *supra*.

The taxpayer wishes also to reply to respondent's reliance on the case of *Clark v. Woodward Construction Co.*, 179 F.(2d) 176 (C.A. 10th, 1950). On page 13 of Respondent's brief appears this quotation from that case:

basis for the computation is unchangeable (Pacific's was not until limitations had run on renegotiation) and though the exact amount may be unknown, if it is not unknowable, the item in such cases is to be treated, for tax purposes, as accrued income"; (3) in cases of doubt, benefit is given to the taxpayer, *Keasbey & Matison Co. v. United States*, 141 F.(2d) 163 (C.A. 3rd, 1944) citing the *Spring City Foundry* rule. These are the principal Circuit Court and Supreme Court decisions on accrued income since the *Liebes* case and leave its rule unchanged.

“Where a taxpayer keeps his books and makes his tax returns on the accrual basis, income accrues when all events have accrued from which liability is determined and the liability has become fixed even though payment is deferred to a time in a subsequent year.”

The complete quotation of this brief paragraph is and should have been as follows:

“Where a taxpayer keeps his books and makes his tax returns on the accrual basis, income accrues when all events have accrued from which liability is determined and the liability has become fixed even though payment is deferred to a time in a subsequent year. *The decisive factor is the creation of an enforceable liability.*” (Italics supplied).

(In that case the highway work for the State of Wyoming was both finished and accepted by the State in 1942. The State’s obligation to pay was fixed by statute in 1942—only the time of payment was postponed.)

In our case no enforceable liability of Pacific Forest Industries to Harbor Plywood was created by the issuance of the credit memos “subject to renegotiation” and none could arise until the unresolved and intervening legal right of the Government to renegotiate Pacific Forest Industries (to which intervening legal right reference was obviously made by issuing the credit memos “subject to renegotiation”) was barred by the statute of limitations. No suit for collection in the courts could have been maintained by Harbor Plywood against Pacific Forest Industries until such periods of limitations had expired (R. 119, 122); therefore, until such time, there could be no accrued income.

B. The Record Supports the Taxpayer's, and Not the Tax Court's, Conclusion.

- 1. The right to receive the income did not and could not arise in the taxable years when the credit memos were issued.**

In part B-1 of his brief respondent contends that the right to receive the income arose in the taxable years (Br. 16-18). In this part of the argument the respondent overlooks or ignores the express finding of the Tax Court that each of the credit memos was issued “*subject to renegotiation*” (R. 128). This finding is amply supported by the record—see Joint Exhibits 6-F (R. 62, 128); 10-J (R. 77, 128); and 3-C (R. 35)—and no assignment of error to such finding has been made by either party. No account receivable arose at the time orders were placed with Harbor Plywood by Pacific. Receivables in favor of the members in ordinary years arose at the time the credit memos were issued. But these years in question were not ordinary years and the memos were, therefore, issued conditionally, *i.e.*, “subject to renegotiation.” But so long as that condition was not barred by limitations, the right to receive the income did not arise and could not be accrued. The only thing Pacific was to pay to its members was what was left after all the legal liabilities and expenses, paid or incurred, were determined. So long as Pacific was legally liable to Renegotiation, Harbor's right to the income represented by the conditional credit memos was not fixed and was not unconditional; nor was the amount fixed or susceptible of ascertainment with reasonable accuracy. Unlike the cases of *United States v. Anderson*, 269 U.S. 422 (1926); *Continental Tie & Lum-*

ber Co. v. United States, supra; Clark v. Woodward Construction, supra, all events had not occurred, when the Pacific credit memos were issued “subject to renegotiation”, which fixed the amount of the credit or determined the liability of Pacific to pay it; all these events occurred when the period of limitations on Renegotiation of Pacific expired, and not before.

2. The “reasonable expectancy” test of the *Liebes* case was not met.

Replying to Part B-2 of Respondent’s brief, arguing that there was a reasonable expectancy of payment of the amounts receivable, the petitioner wishes to advance these points:

(a) There could be no such reasonable expectancy so long as the unresolved and intervening legal right as was created by the Renegotiation Act itself was not barred by the Statute of Limitations, see Part E of Petitioner’s brief.

(b) Such renegotiation was not only possible but highly probable, see Part B of Petitioner’s brief. Respondent completely ignores the emphatic language in Joint Exhibit 7-G (R. 64-66):

“... Consequently, I am directed to require that your accounts be renegotiated.”

and also disregards the fact that such threats were actual, strong, continuous and definite (R. 57, 64, 70, 77), that they were not mere requests for information. Respondent also completely disregards the fact that these threats were made not only by letter but also by official statements in personal conferences with the

Treasury Department attended by counsel and general manager of Pacific (R. 111-114), who endeavored without success at these conferences to obtain an unconditional clearance for Pacific from renegotiation (R. 111). The only clearance obtained by Pacific, namely, the letter from Treasury Procurement dated June 21, 1944 (R. 77-78), was clearly conditional in its terms: it was limited to Pacific's fiscal year ending March 31, 1944 (not 1943) and did "not operate as a release of liability under the Renegotiation Statute."

(c) The fact that Pacific was never actually renegotiated is irrelevant. It is viewing the matter, as the Commissioner is all too often prone to do, with hindsight and not foresight. At the time the credit memos were issued and the decisions as to accrual were made in good faith who could say there would be no Renegotiation? In cases of doubt, benefit is given to the taxpayer, *Frost Lumber Industries v. Commissioner, supra*.¹ Nor is it correct, as the Tax Court states (R. 130) and as Respondent argues (Br. 20), that Pacific was sustained in its contention of being free from Renegotiation. The letter of June 21, 1944 (R. 77-78), referred to above, did not unconditionally sustain such contention. Strained construction in administrative efforts to accrue income should be avoided, *Frost Lumber Industries v. Commissioner, supra*.

3. The *Liebes* case alone justifies reversal; respondent did not, and can not, logically demonstrate its inapplicability here.

Replying to Respondent's argument B 3, that none of the cases cited by the taxpayer furnish a basis for

reversal, the petitioner submits that the Respondent's attempt to point out the inapplicability of the *Liebes* case, *supra*, was to no avail. Respondent again ignores the fact found by the Tax Court that all credit memos were issued "subject to renegotiation." True, it was Pacific and not Harbor Plywood, the taxpayer, who was disputing and "litigating," as it were, the Renegotiation question and it was subject to such dispute and litigation that the credit memos were issued. Hence, by incorporating such condition by reference into the credit memos, the taxpayer's position here actually was like the taxpayer's position in the *Liebes* case. To hold otherwise is to make the same error in logic that the Tax Court made as to the patronage dividend argument (see Petitioner's Brief, p. 40-41), namely, it would raise the taxpayer, Harbor Plywood's, right to such income to a higher degree of certainty and to a more reasonable degree of expectancy and would find the amount thereof susceptible of a more accurate ascertainment, than the source of such income. This, of course, is a logical absurdity. Hence, the *Liebes* case is not, in fact, distinguishable in principle; instead, the *Liebes* case alone justifies reversal.

4. The *Lester Smith* case, 8 T.C.M. 385 (1949), is applicable by way of analogy.

Replying to B 4 of Respondent's argument, petitioner recognizes that it is an accrual basis taxpayer and that cases dealing with "constructive receipt" by cash basis taxpayers are not squarely in point. Such "constructive receipt" cases, as stated in part D of petitioner's brief (Br. 41-42) and elsewhere (Br. 28-

31) are, however, persuasive by way of analogy. It requires no citation of authority to support the proposition that analogy has played a strong role in the evolution of case law. The petitioner can find no case dealing squarely with the Renegotiation problem confronting the accrual basis taxpayer before this Court and Respondent has cited no such case. This Court will have to apply established principles, and perhaps reason, in part, by analogy to determine the correct result in the case at bar. As an aid in arriving at such result the petitioner cited and discussed at length the case of *Lester C. Smith, Mary B. W. Smith v. Commissioner*, 8 T.C.M. 385 (1949) dealing with the Renegotiation (under the same Renegotiation Act of 1942 involved in the case at bar) of an employer and the impact of such Renegotiation on the "constructive receipt" of income by an employee, a cash basis taxpayer, whose income from compensation was "subject to renegotiation." (See Petitioner's Brief, p. 28-32, 41-43).

Petitioner again respectfully invites the attention of this Court to the fact that the Tax Court refused to consider or even mention such case (notwithstanding that it was cited and argued extensively in the Tax Court briefs) and the Respondent has followed suit by ignoring this *Smith* case completely without any attempt to distinguish it. I am sure this Court will agree that the *Smith* case presents a persuasive argument by way of analogy in support of Petitioner's position.

III.

CONCLUSION

In view of the foregoing facts and the arguments advanced in petitioner's opening brief and in this Reply brief, petitioner prays that the Tax Court be reversed and that it be directed to enter an order in this case of either (1) "No deficiency"; or, in the alternative, (2) to compute the correct deficiencies, if any, for each of said years in question in accordance with the decision of this Court that the amounts represented by the credit memoranda issued by Pacific Forest Industries to Harbor Plywood Corporation were taxable to Harbor Plywood Corporation and should have been accrued by it as taxable income in the years when the statute of limitations barred Renegotiation of Pacific Forest Industries, and not before.⁴

Respectfully submitted,

WARREN A. DOOLITTLE
Attorney for Petitioner

February, 1950

⁴ The deficiencies of tax owing under this second alternative have already been agreed to between the parties (R. 29-30).

No. 12664

United States
Court of Appeals
for the Ninth Circuit.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,
vs.

GRACE H. KELHAM, LEILA H. NEILL, ELLIS
M. MOORE, HARRIET H. BELCHER, and
LILLIE S. WEGEFORTH,
Respondents.

Transcript of Record

Petitions to Review Decisions of the Tax Court
of the United States.

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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in *italic*; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in *italic* the two words between which the omission seems to occur.]

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APPEARANCES

For Petitioner:

LEON DE FREMERY, ESQ.

For Respondent:

W. J. McFARLAND, ESQ.,

T. M. MATHER, ESQ.

Transferred to Judge Murdock 4/19/49

Transferred to Judge Turner 6/30/49

Docket No. 5333

GRACE H. KELHAM,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DOCKET ENTRIES

1944

June 12—Petition received and filed. Taxpayer notified. Fee Paid.

June 13—Copy of petition served on General Counsel.

June 12—Request for Circuit hearing in San Francisco, Calif., filed by taxpayer. 6/15/44 Granted.

July 24—Answer filed by General Counsel.

July 27—Copy of answer served on taxpayer, San Francisco, Calif.

1947

Aug. 22—Hearing set Nov. 3, 1947—San Francisco, Calif.

Nov. 3—Hearing had before Judge Tyson on merits, motion of Respondent and Petitioner to consolidate, Granted. Stip. of facts, Supplement Stip. of facts filed at hearing. Briefs 50 days; replies 40 days.

1947

Nov. 12—Transcript of hearing 11/3/47 filed.

Dec. 22—Brief filed by taxpayer. P. 12/24/47
copy served.

Dec. 23—Brief filed by General Counsel.

1948

Jan. 27—Motion for extension to Mar. 2, 1948, to
file reply brief by G. C. 1/28/48 Granted.

Feb. 2—Reply brief filed by taxpayer (P). Copy
served.

Mar. 9—Motion for leave to file the attached reply
brief; brief lodged and filed by General
Counsel. 3/10/48 Granted.

1949

Dec. 20—Opinion rendered, Judge Turner. Deci-
sion will be entered under Rule 50. Served
12/21/49.

1950

Feb. 28—Respondent's computations for entry of
decision filed.

Feb. 28—Consent to respondent's computation filed
(letter).

Mar. 14—Decision entered, Judge Turner, Divi-
sion 8.

Mar. 17—Agreement to entry of decision under
Rule 50 filed by taxpayer.

1950

June 2—Petition for review by U. S. Circuit Court of Appeals, 9th Circuit, filed by General Counsel.

June 12—Proof of service of petition for review filed (2) on taxpayer and counsel for taxpayer.

June 29—Motion for extension of time to Aug. 31, 1950, to prepare and transmit the record filed, by General Counsel.

June 29—Order enlarging the time to August 31, 1950, to prepare and transmit the record entered.

July 26—Statement of points filed by General Counsel with statement of service thereon.

July 26—Statement re diminution of record filed by General Counsel with statement of service thereon.

The Tax Court of the United States

Docket No. 5333

GRACE H. KELHAM,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (San Francisco-IRA:90D-LB) dated May 26, 1944, and as a basis of her proceeding alleges as follows:

1. Petitioner is an individual, whose mailing address is 1110 Crocker Building, San Francisco, California. The return for the period here involved was filed with the Collector for the First District of California.

2. The notice of deficiency (a copy of which is attached hereto and marked "Exhibit A") was mailed to petitioner on May 26, 1944.

3. The taxes in controversy are income taxes for the calendar year 1940 and in the amount of \$48,251.62.

4. The determination of tax set forth in said notice of deficiency is based on the following errors:

(a) The Commissioner erred in disallowing as a deduction interest paid by petitioner during the calendar year 1940 in the amount of \$5,273.73.

(b) The Commissioner erred in determining that distributions made by J. D. and A. B. Spreckels Company to its stockholders during the calendar year 1940 were paid out of earnings or profits to the extent of 100% thereof, and as a result of said determination increasing petitioner's income for the year 1940 by the amount of \$91,843.20; and the Commissioner erred in failing to find that at least 79.792% of said distributions were not paid out of earnings or profits.

5. The facts upon which petitioner relies as the basis of this proceeding are as follows:

(a) Petitioner deducted from gross income on line 14 of her Income Tax Return (Form 1040) for the calendar year 1940 interest in the total sum of \$8,533.24, which said total sum included interest in the amount of \$2,250.25 paid by petitioner to the Collector of Internal Revenue during the calendar year 1940, and interest in the amount of \$3,023.48 paid to the State Treasurer of the State of California during the calendar year 1940, under the circumstances hereinafter set forth.

(b) Petitioner is one of the two daughters of Grace S. Hamilton, who died on January 23, 1937, leaving an estate subject to probate with an appraised value at the date of death of \$144,429.26. The debts of decedent and administration expenses of said estate totalled \$129,006.92. Said decedent

had made transfers prior to her death of a substantial portion of her property, and the Commissioner of Internal Revenue determined that a portion of said transfers was includible in the gross estate of said decedent and subject to federal estate tax. The federal estate tax payable by the estate of said decedent, including the taxable portion of said transfers as finally determined by said Commissioner, was the sum of \$672,809.04.

(c) Petitioner and her sister were each transferees of one-half of said transfers made by said decedent prior to her death, including the taxable portion of said transfers as finally determined by said Commissioner in determining the amount of said federal estate tax as aforesaid, and petitioner as such transferee was personally liable for the payment of said tax.

(d) The federal estate tax shown to be due by the return (Form 706) filed for said estate was \$642,119.42. During the calendar year 1938 petitioner and her said sister paid to the Collector of Internal Revenue the tax shown to be due by said return in equal proportions as between themselves.

(e) During the calendar year 1940 said Commissioner determined that there was a deficiency in federal estate tax due from the estate of said decedent in the amount of \$39,270.78 and on June 18, 1940, petitioner and her said sister paid to the Collector of Internal Revenue said deficiency together with interest in the amount of \$4,500.51 in equal proportions as between themselves. Peti-

tioner's proportion of said interest was the sum of \$2,250.25.

(f) The Inheritance Tax Appraiser of the State of California determined that a portion of said transfers made by said decedent prior to her death was subject to state inheritance taxes, and said taxes became due and payable on January 23, 1939. The total amount of said taxes was the sum of \$182,857.20, one-half of said sum having been assessed on account of petitioner's interest in said estate and in said transfers, and in certain insurance moneys received by reason of the death of said decedent. On January 20, 1939, petitioner and her said sister, in equal proportions as between themselves, paid to the State Treasurer of the State of California on account of said state inheritance taxes the sum of \$131,026.00. On September 23, 1940, petitioner and her said sister, in equal proportions as between themselves, paid to said State Treasurer of the State of California the balance of said state inheritance taxes in the amount of \$51,831.20 together with interest thereon in the amount of \$6,046.97. Petitioner's proportion of said interest was the sum of \$3,023.48.

(g) The Commissioner has erroneously disallowed the deduction of said interest in the amount of \$2,250.25 paid to the Collector of Internal Revenue and said interest in the amount of \$3,023.48 paid to said State Treasurer, taken by petitioner on her income tax return as aforesaid.

(h) During the calendar year 1940 petitioner

owned directly 6 shares of the capital stock of J. D. and A. B. Spreckels Company and voting trust certificates representing 972 shares of the capital stock of said corporation. During the calendar year 1940 petitioner was a beneficiary of a trust known as the Grace S. Hamilton Trust, Crocker First National Bank of San Francisco, et al., trustees, and as such beneficiary was entitled to receive one-half of the income of said trust during said year. Included in the assets of said trust during said year were voting trust certificates representing 1340 shares of the capital stock of J. D. and A. B. Spreckels Company.

(i) During the calendar year 1940 J. D. and A. B. Spreckels Company made distributions to its stockholders in the amount of \$68.00 per share. Petitioner received, either directly or indirectly, from said distributions the sum of \$112,064.00. On her Income Tax Return (Form 1040) for the calendar year 1940 petitioner excluded approximately 82% of said distributions as non-taxable distributions and reported approximately 18% thereof as follows: On line 2 (included in the sum of \$12,261.23) the sum of \$11,922.64 representing dividends received on 978 shares; and on line 7, as income received from said Grace S. Hamilton Trust (included in the sum of \$10,327.56) the amount of \$8,200.80 representing dividends on 670 shares.

(j) The Commissioner has erroneously increased petitioner's dividend income, reported on line 2 of her said return, by the amount of \$54,484.00 and

has erroneously increased petitioner's fiduciary income, reported on line 7 of her return, by the amount of \$37,359.20. The total of said adjustments in the amount of \$91,843.20 represents approximately 82% of the distributions received by petitioner, either directly or indirectly, from J. D. and A. B. Spreckels Company during the calendar year 1940 and which petitioner did not report on the ground that such distributions constituted non-taxable distributions as aforesaid.

(k) Petitioner alleges that only a portion of said cash distributions in the sum of \$112,064.00 received by petitioner, either directly or indirectly, during the calendar year 1940 from said J. D. and A. B. Spreckels Company, to wit: the sum of not more than \$22,645.89 was paid out of the earnings or profits of said corporation accumulated after February 28, 1913, or out of its earnings or profits for the calendar year 1940, and that the balance of said sum of \$112,064.00, to wit: an amount not less than the sum of \$89,418.11, was not paid out of the earnings or profits of said corporation accumulated after February 28, 1913, nor out of its earnings or profits for the taxable year 1940, and that said balance was not subject to income tax in the hands of and was not taxable to petitioner.

(1) Petitioner is informed and believes, and therefore alleges, that on January 1, 1940, J. D. and A. B. Spreckels Company had no earnings or profits accumulated since March 1, 1913, and that its earnings or profits for the calendar year 1940

did not exceed \$274,827.56. During the calendar year 1940 J. D. and A. B. Spreckels Company made distributions to its stockholders in the amount of \$1,360,000.

(m) The basis to petitioner on January 1, 1940, for income tax purposes, of each share of the capital stock of J. D. and A. B. Spreckels Company, and of each share of said stock represented by voting trust certificates, held by said petitioner during the calendar year 1940, was greater than the aggregate cash distributions made by said corporation during said year on each of said shares. The basis to said Grace S. Hamilton Trust on January 1, 1940, for income tax purposes, of each share of stock represented by voting trust certificates, held by said trust during the calendar year 1940, was greater than the aggregate cash distributions made by said corporation during said calendar year 1940 on each of said shares.

Wherefore, petitioner prays that this Court may hear this proceeding and determine that the deficiency in income tax for the calendar year 1940 does not exceed \$406.53.

/s/ LEON DE FREMERY,
Counsel for Petitioner.

State of California,
City and County of San Francisco—ss.

Grace H. Kelham, being duly sworn, says:

That she is the petitioner above named; that she has read the foregoing petition, or had the same read to her, is familiar with the statements con-

tained therein, and that the statements contained therein are true, except those stated to be upon information and belief, and those she believes to be true.

/s/ GRACE H. KELHAM.

Subscribed and sworn to before me this 7th day of June, 1944.

[Seal] /s/ W. W. HEALLY,
Notary Public in and for the City and County of
San Francisco, State of California.

EXHIBIT A

Form 1230.

Treasury Department
Internal Revenue Service
74 New Montgomery Street
San Francisco 5, California

Office of
Internal Revenue Agent in Charge
San Francisco Division

IRA:90-D-LB
(C:TS:PD SF:WGW)

May 26, 1944.

Mrs. Grace H. Kelham
11th Floor Crocker Building
San Francisco, California

Dear Mrs. Kelham:

You are advised that the determination of your income tax liability for the taxable year ended De-

cember 31, 1940, discloses a deficiency of \$48,658.15 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency mentioned.

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with The Tax Court of the United States for a redetermination of the deficiency.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Internal Revenue Agent in Charge, San Francisco 5, California, for the attention of—Conference Section. The signing and filing of this form will expedite the closing of your return(s) by permitting an early assessment of the deficiency, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,

JOSEPH D. NUNAN, JR.,
Commissioner.

By F. M. HARLESS,
Internal Revenue Agent in
Charge.

HJB

Enclosures:

Statement.

Form of waiver.

Statement

San Francisco
 IRA:90-D-LB
 (C:TS:PD
 SF:WGW)

Mrs. Grace H. Kelham
 11th Floor Crocker Building
 San Francisco, California

Tax Liability for the Taxable Year Ended December 31, 1940

	Liability	Assessed	Deficiency
Income Tax	\$49,358.78	\$700.63	\$48,658.15

In making this determination of your income tax liability, careful consideration has been given to your protest dated March 10, 1943, and to the statements made at the conferences held on April 30, 1943, February 15, 1944, and February 23, 1944.

A copy of this letter and statement has been mailed to your representative, Mr. Leon de Fremery, 1110 Crocker Building, San Francisco, California, in accordance with the authority contained in the power of attorney, executed by you and on file in this office.

Adjustments to Net Income

Net income as disclosed by return.....\$11,966.80

Unallowable deductions and additional income:

(a) Dividends	\$54,484.00	
(b) Fiduciary income	37,368.25	
(c) Rental income	277.50	
(d) Interest	5,273.73	97,403.48
Net income adjusted		\$109,370.28

Explanation of Adjustments

(a) and (b). Dividends received directly from J. D. and A. B. Spreckels Co. and reported on your return are revised as follows:

Amount received	\$66,406.64
Reported on line 2 of your return, 18 per cent or.....	11,922.64
Balance, 82 per cent, held to be taxable.....	\$54,484.00
Dividends from J. D. and A. B. Spreckels Co. received through trust u/d Grace S. Hamilton, total....	\$47,686.76
Reported on line 7 of your return.....	10,327.56
Balance, 82 per cent, held to be taxable.....	\$37,359.20

Add: Trustee's expense allocable to exempt interest under section 24(a) (5) Internal Revenue Code	9.05
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Total increase in fiduciary income.....	\$37,368.25
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You contend that your share of distributions by J. D. and A. B. Spreckels Company, a corporation, in which you owned stock directly and in which trusts of which you were a beneficiary owned stock, is taxable to the extent of only 18 per cent. It is held that the distributions are out of earnings and profits accumulated after February 28, 1913, and are taxable as dividends in their entirety.

(1) Gross rental income, from 2006 Washington Street, a community apartment was received in the amount of \$2,497.50 in place of \$2,220.00 as shown on your return. Taxable net income is therefore increased in the amount of \$277.50.

(d) You claimed on your income tax return for 1940, deductions for interest upon deficiencies in federal estate tax and state inheritance tax in the amounts of \$2,250.25 and \$3,025.48, respectively, said amounts relating to the Estate of Grace S. Hamilton, Deceased. It is held that the above-mentioned amounts aggregating \$5,273.73 were not paid on your indebtedness and are not deductible. See section 23(b) of the Internal Revenue Code.

Computation of Alternative Tax
(Section 117 (c)—Internal Revenue Code)

Net income	\$109,370.28
Plus: Net long-term capital loss.....	128.49
Ordinary net income	\$109,498.77
Less: Personal exemption	\$2,000.00
Credit for dependents	800.00 2,800.00
Balance (surtax net income)	\$106,698.77
Less: Earned income credit	349.50
Net income subject to normal tax.....	\$106,349.27
Normal tax at 4 per cent on \$106,349.27.....	\$ 4,253.97
Surtax on \$106,698.77.....	40,665.29
Partial tax	\$ 44,919.26
Minus: 30 per cent of net long-term loss.....	38.55
Alternative tax	\$ 44,880.71

Computation of Tax

Net income adjusted	\$109,370.28
Less: Personal exemption	\$2,000.00
Credit for dependents	800.00 2,800.00
Balance (surtax net income)	\$106,570.28
Less: Earned income credit	349.50
Net income subject to normal tax.....	\$106,220.78
Normal tax at 4 per cent on \$106,220.78.....	\$ 4,248.83
Surtax on \$106,570.28.....	40,590.76
Total tax (Ordinary rates)	\$ 44,839.59
Alternative tax	\$ 44,880.71
Add: Defense tax—10 per cent.....	4,488.07
Total tax	\$ 49,368.78
Less: Income tax paid at the source.....	10.00
Correct income tax liability	\$ 49,358.78
Income tax assessed:	
Original, account No. 848617—	
First California District	700.63
Deficiency of income tax	\$ 48,658.15

Received and filed June 12, 1944, T.C.U.S.

[Title of Tax Court and Cause.]

Docket No. 5333

ANSWER

Comes now the Commissioner of Internal Revenue, respondent above named, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition filed by the above-named petitioner, admits and denies as follows:

1. Admits the allegations contained in paragraph 1 of the petition.

2. Admits the allegations contained in paragraph 2 of the petition.

3. Admits that the taxes in controversy are income taxes for the calendar year 1940; denies all other allegations contained in paragraph 3 of the petition.

4. (a) and (b). Denies that the determination of tax set forth in the notice of deficiency is based upon errors as alleged in paragraph 4 and subparagraphs (a) and (b) thereunder of the petition.

5. (a) Admits that the petitioner deducted from gross income on line 14 of her income tax return (Form 1040) for the calendar year 1940 interest in the total sum of \$8,533.24; for lack of information and belief, denies all other allegations contained in subparagraph (a) of paragraph 5 of the petition.

(b) Admits that the petitioner is one of the daughters of Grace S. Hamilton, who died during 1937, leaving an estate subject to probate. For lack of information and belief, denies all other allegations contained in subparagraph (b) of paragraph 5 of the petition.

(c) and (d) For lack of information and belief, denies all allegations contained in subparagraphs (c) and (d) of paragraph 5 of the petition.

(e) Admits that during the calendar year 1940 said Commissioner determined that there was a deficiency in Federal estate tax due from the estate of said decedent; for lack of information and belief,

denies all other allegations contained in subparagraph (e) of paragraph 5 of the petition.

(f) For lack of information and belief, denies all allegations contained in subparagraph (f) of paragraph 5 of the petition.

(g) Denies the allegations contained in subparagraph (g) of paragraph 5 of the petition.

(h) Admits that during the calendar year 1940 petitioner owned shares of capital stock of J. D. and A. B. Spreckels Company and trust certificates representing shares of the capital stock of said corporation; admits that during the calendar year 1940 petitioner was a beneficiary of the trust known as the Grace S. Hamilton Trust, Crocker First National Bank of San Francisco, et al., Trustees, and as such beneficiary was entitled to receive income of said trust during said year; admits that included in the assets of said trust during said year were trust certificates representing shares of the capital stock of J. D. and A. B. Spreckels Company; for lack of information and belief, denies all other allegations contained in subparagraph (h) of paragraph 5 of the petition.

(i) Admits that during the calendar year 1940 J. D. and A. B. Spreckels Company made distributions to its stockholders; admits that petitioner received certain of said distributions and that on her income tax return (Form 1040) for the calendar year 1940 she excluded portions of said distributions on the theory that such portions were non-taxable; for lack of information and belief, denies all other allegations contained in subparagraph (i) of paragraph 5 of the petition.

(j) Admits that the Commissioner has increased petitioner's dividend income, reported in line 2 of her said return, by the amount of \$54,484.00, and has increased petitioner's fiduciary income, reported on line 7 of her return, by the amount of \$37,359.20, but denies that said increases were erroneously made; for lack of information and belief, denies all other allegations contained in subparagraph (j) of paragraph 5 of the petition.

(k) Denies the allegations contained in subparagraph (k) of paragraph 5 of the petition.

(l) and (m) For lack of information and belief, denies all allegations contained in subparagraphs (l) and (m) of paragraph 5 of the petition.

6. Denies generally and specifically each and every allegation in the petition not hereinbefore admitted, qualified, or denied.

Wherefore, it is prayed that the Commissioner's determination be approved and the petitioner's appeal denied.

/s/ J. P. WENCHEL,
Chief Counsel, Bureau of
Internal Revenue.

Of Counsel:

B. H. NEBLETT,
Division Counsel,

T. M. MATHER,
ARTHUR L. MURRAY,
Special Attorneys,
Bureau of Internal Revenue.

Received and filed July 24, 1944, T. C. U. S.

The Tax Court of the United States

Docket No. 5333

GRACE H. KELHAM,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Docket No. 5334

LEILA H. NEILL,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Docket No. 5495

ELLIS M. MOORE,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Docket No. 5559

HARRIET H. BELCHER,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Docket No. 5560

LILLIE S. WEGEFORTH,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

STIPULATION OF FACTS RE
DIVIDEND ISSUE

It Is Hereby Stipulated and Agreed by and between the parties hereto, by their respective attorneys, that the following facts shall be taken as true upon the trial of the above-entitled cases, provided, however, that this stipulation shall be without prejudice to the right of either party to introduce other and further evidence not inconsistent with the facts herein stipulated to be taken as true.

During the calendar years 1938, 1939 and 1940, petitioners (and others) received dividends from J. D. and A. B. Spreckels Company, the taxability of which is in issue between the parties to this proceeding and will depend upon the final decision rendered with respect to the following issues:

1. Whether the transfer by Oceanic Steamship Company on November 16, 1912, of 23,647 shares of its stock to J. D. Spreckels & Bros. Company in consideration for the cancellation and surrender by J. D. Spreckels & Bros. Company of notes payable by Oceanic Steamship Company to J. D. Spreckels & Bros. Company reduced the operating deficit of said Oceanic Steamship Company.

2. Whether the operating deficits of Oceanic Steamship Company and Kilauea Sugar Plantation Company as of March 1, 1913, must be restored by subsequent earnings or profits in determining the amount of earnings or profits available for dividends.

3. Whether the operating deficits of Seventh and Hill Building Corporation and Monterey County Water Company, wholly-owned subsidiaries of J. D. and A. B. Spreckels Company, were transferred to J. D. and A. B. Spreckels Company at the time of the liquidation of the said wholly-owned subsidiaries.

I.

Facts relating to issue numbered (1) above

(1) Oceanic Steamship Company was incorporated under the laws of the State of California on December 24, 1881, with an authorized capital of 25,000 shares of common capital stock of the par value of \$100 per share. Payment of the subscription price of \$100 per share for the original stock

issue of 25,000 shares was made by the corporation calling for the payment in installments over a period of twenty years. These installments of the subscription price were described in the books of account of the corporation as "assessments." By the end of 1902 the original issue of stock was fully paid up, \$2,500,000.00 in cash having been paid in therefor.

(2) On April 29, 1903, an additional 25,000 shares of stock of the par value of \$100 per share was authorized and was thereafter issued on April 30, 1903, to stockholders of record pro rata. Upon the issuance of this stock, the Capital Stock account was credited with \$2,500,000 and an account entitled "Stock Bonus Account" was debited in like amount, and at all times thereafter during the existence of the corporation the Capital Stock account remained at \$5,000,000. At the date of this transaction the corporation had a deficit in excess of \$1,500,000, of which approximately \$750,000 resulted from operations of the business. Thereafter assessments were levied by the corporation on all outstanding capital stock, and as these assessments were levied they were credited to the Stock Bonus account. The following schedule per books reflects: (a) Date of assessment; (b) Applicable to Number of Shares; (c) Amount per Share; (d) Amount Total Assessment; (e) Amount Paid, and (f) Amount Unpaid:

Applicable Amt.						
Date of	to No. of	per	Total	Amount		
Assessment	Shares	Share	Assessment	Amt. Paid	Unpaid	
#20— 2/20/06	50,000	\$ 2.00	\$ 100,000.00	\$ 74,094.00	\$ 25,906.00	
#21— 3/19/07	37,047	10.00	370,470.00	264,490.00	105,980.00	
#22— 5/ 8/07	26,449	10.00	264,490.00	264,480.00	10.00	
#23— 6/29/07	26,448	10.00	264,480.00	263,530.00	950.00	
#24— 8/20/07	26,353	10.00	263,530.00	263,530.00	-----	
#25—10/ 3/07	26,353	10.00	263,530.00	263,530.00	-----	
				134,210.26		
			\$52.00	\$1,526,500.00	\$1,393,654.00	\$132,846.00
			1,364.26			

[Italicised figures appear in pencil on original.]

(3) The shares of stock on which the assessments listed in the preceding schedule had not been paid were bid in by the corporation pursuant to delinquency sale and thereafter carried on its books as treasury stock in the amount of \$134,210.26. Said \$134,210.26 represented the total of the unpaid assessments for which these shares were bid in together with charges in connection therewith. The capital stock record maintained by Oceanic Steamship Company reflects the following:

Date of Issuance	Cert. No.	Issued in Name of	No. of Shares
9/21/1906.....	#1261	Oceanic Steamship Co.	12,953
5/ 6/1907.....	#1260	Oceanic Steamship Co.	10,598
6/28/1907.....	#1262	Oceanic Steamship Co.	1
8/19/1907.....	#1263	Oceanic Steamship Co.	95

(4) On November 16, 1912, Oceanic Steamship Company transferred said 23,647 shares of its stock to J. D. Spreckels & Bros. Company in consideration of the cancellation and surrender to Oceanic Steamship Company by J. D. Spreckels & Bros. Company of notes of Oceanic Steamship Company

in the principal sum of \$1,204,070.48 together with accrued interest thereon in the amount of \$79,623.91. Said transfer was made pursuant to resolutions of the Boards of Directors of Oceanic Steamship Company and J. D. Spreckels & Bros. Company, true copies of which are attached hereto and marked Exhibits 1-A and 2-B, respectively, hereof. The certificates referred to in paragraph three hereof were cancelled on November 16, 1912, and on that date Certificate #1275 for 23,647 shares of capital stock of Oceanic Steamship Company was issued by the latter to J. D. Spreckels & Bros. Company.

(5) Oceanic Steamship Company made the following entries on its books of account: On November 16, 1912, it charged "Bills Payable" with the principal sum of said notes in the amount of \$1,204,070.48 and charged "Interest Accrued on Notes" with the accrued interest thereon in the amount of \$79,623.91, the total of these two items in the amount of \$1,283,694.39 being credited to an account entitled "Deficiency"; and the Treasury Stock account was credited with the balance remaining in said account in the amount of \$134,210.26 and this amount was charged to said "Deficiency" account. On December 31, 1912, the balance of \$973,500.00 remaining in the Stock Bonus account was written off and this amount was charged to said "Deficiency" account.

(6) On October 31, 1912, Oceanic Steamship Company had total assets per books, exclusive of said treasury stock, in the amount of \$3,746,134.32 and total liabilities (other than capital) of \$3,942,-

122.59. Except for depreciation in the amount of \$101,127.86 taken in prior years on one vessel, no depreciation had ever been entered in its books by the company on the three steamers then owned by it, and at a special meeting of the Board of Directors held on November 16, 1912, the Secretary of the company was instructed to write down the value of its steamers as of December 31, 1912, in the total amount of \$1,553,386.45, which was the amount required to make the book values of the three steamers correspond to their total appraised valuation of \$2,041,222.00. This write-off was charged to depreciation and it is agreed that said charge was proper. Applying this adjustment to the aforesaid book values of the assets of Oceanic Steamship Company as of October 31, 1912, gives a corrected book value of \$2,192,747.87 or \$1,749,374.72 less than the liabilities. Attached hereto and marked "Exhibit 3-C" are balance sheets per books of Oceanic Steamship Company as of October 31, 1912, and December 31, 1912.

(7) In 1899 and 1900 Oceanic Steamship Company issued \$2,500,000 first mortgage 5% bonds, of which \$2,405,000 were outstanding in 1906 and \$1,803,000 were outstanding in 1912. Beginning with the semi-annual interest payment due July 1, 1906, the company began to default on the payment of interest on these bonds, the payments made being about six months in arrears, funds being borrowed from J. D. Spreckels & Bros. Company to pay delinquent interest from time to time. Beginning with the coupon due July 1, 1909, no interest was

paid until December, 1915, when the interest due for the period January 1, 1909, to July 1, 1911, inclusive, was paid. All of the outstanding bonds were redeemed in 1917 and interest thereon paid in full.

(8) The investment of J. D. Spreckels & Bros. Company in the capital stock of Oceanic Steamship Company was reflected on its books as follows:

	Shares	Investment Per Books
Purchased 1881-1907	18,303	\$ 807,135.23
Assessments paid 1906-1907		903,778.00
Received in 1912 in payment of notes and accrued interest	23,647	1,113,732.50
Total.....	41,950	\$2,824,645.73

The difference between said face value of said notes in the amount of \$1,204,070.48 as hereinabove stated (Paragraph 4) and the amount of \$1,113,732.50 set forth in the above schedule is due to accrued interest included in the face value of said notes but not accrued on the books of J. D. Spreckels & Bros. Company. Similarly, the accrued interest on said notes in the amount of \$79,623.91 referred to in Paragraph 4 hereof had not been accrued on the books of J. D. Spreckels & Bros. Company. On December 10, 1913, the directors of J. D. Spreckels & Bros. Company authorized the writedown of the investment of that company in the stock of Oceanic Steamship Company totalling 41,950 shares, from a cost of \$2,824,645.73 to \$100.00. The parties to this proceeding, in agreeing upon the settlement of other issues involved in the taxability of dividends declared by J. D. and A. B. Spreckels Company,

have agreed that the capital stock of Oceanic Steamship Company was worthless as of September 26, 1912, the date of the transfer of the stock of J. D. Spreckels & Bros. Company to J. D. and A. B. Spreckels Securities Company, the predecessor of J. D. and A. B. Spreckels Company. The acquisition and disposition of said 23,647 shares of capital stock were the only transactions Oceanic Steamship Company ever had in its capital stock other than the original issuance thereof.

(9) From July 28, 1907, to September 26, 1912, J. D. Spreckels and A. B. Spreckels, either directly or through ownership of J. D. Spreckels & Bros. Company, owned in excess of 96% of the outstanding capital stock of Oceanic Steamship Company, exclusive of said treasury stock. From its incorporation in 1892 to September 26, 1912, the capital stock of J. D. Spreckels & Bros. Company was entirely owned, with the exception of directors' qualifying shares, by J. D. Spreckels and A. B. Spreckels in equal amounts. On September 26, 1912, said capital stock was transferred by said brothers together with other property to J. D. and A. B. Spreckels Securities Company in exchange for all its capital stock, and thereafter and until 1922 said brothers owned in equal amounts all of said outstanding capital stock. J. D. and A. B. Spreckels Securities Company continued to own all the outstanding capital stock of J. D. Spreckels & Bros. Company after the acquisition of said stock on September 26, 1912, as aforesaid until the dissolution of the last named company on July 12, 1928.

(10) On September 26, 1912, and until the transfer of said 23,647 shares of the capital stock of Oceanic Steamship Company to J. D. Spreckels & Bros. Company as aforesaid on November 16, 1912, the outstanding capital stock of Oceanic Steamship Company, exclusive of said treasury stock, was owned as follows:

18,303 shares or 69.45% by J. D. Spreckels & Bros. Company and 8,050 shares or 30.55% by J. D. and A. B. Spreckels Securities Company.

(11) The indebtedness of Oceanic Steamship Company to J. D. Spreckels & Bros. Company above referred to in the principal amount of \$1,204,070.48 represented moneys advanced for financing the activities of Oceanic Steamship Company, together with accrued interest in undisclosed amounts.

(12) On the basis of the foregoing facts, respondent contends that Oceanic Steamship Company realized a gain of \$1,149,484.13 or otherwise reduced its operating deficit by that amount upon the transfer of 23,647 shares of its capital stock to J. D. Spreckels & Bros. Company in 1912 computed as follows:

Principal amount of notes cancelled . . .	\$1,204,070.48
Accrued interest thereon	79,623.91
	<hr/>
	\$1,283,694.39
Less bid in price on delinquent stock	
sales	134,210.26
	<hr/>
	\$1,149,484.13

On the other hand, petitioners contend that said transaction was a capital transaction which did not result in any realization of gain or otherwise reduce the operating deficit of Oceanic Steamship Company.

II.

Facts relating to issue numbered (2) above

(13) As of March 1, 1913, Oceanic Steamship Company and Kilauea Sugar Plantation Company had operating deficits in the following amounts:

Oceanic Steamship Company

In the event issue numbered (1)
above is decided in favor of
petitioners\$4,878,987.40

In the event issue numbered (1)
above is decided in favor of
respondent\$3,729,503.27

Kilauea Sugar Plantation Company...\$ 308,429.18

(14) Subsequent to March 1, 1913, Oceanic Steamship Company and Kilauea Sugar Plantation Company realized earnings or profits and declared certain dividends as hereinafter set forth. The question presented for the decision of the court is whether the earnings or profits of said companies realized subsequent to March 1, 1913, must first be applied to eliminate said operating deficits as of March 1, 1913, before said corporations can have accumulated earnings or profits available for dividends.

(15) On November 18, 1936, Oceanic Steamship

Company transferred all its assets to J. D. and A. B. Spreckels Company in complete liquidation within the meaning of Section 112 (b)(6) of the Revenue Act of 1936. On said date and since the year 1917 Oceanic Steamship Company was a wholly-owned subsidiary of J. D. and A. B. Spreckels Company, or its predecessor J. D. and A. B. Spreckels Securities Company.

(16) The following schedule shows the operating deficit of Oceanic Steamship Company as of March 1, 1913; the earnings or profits of said company realized subsequent thereto; the dividends paid; and the accumulated earnings or profits transferred to J. D. and A. B. Speckels Company upon the liquidation of Oceanic Steamship Company. All of said figures are shown in four columns, in order to show the results depending upon whether the operating deficit as of March 1, 1913, does or does not have to be made up from subsequent earnings or profits and also to show the result in the event that issue (1) above is decided in favor of petitioner or is decided in favor of respondent:

Oceanic Steamship Company

	March 1, 1913 Operating Deficit Made Up From Subsequent Earnings or Profits	March 1, 1913 Operating Deficit Not Made Up From Subsequent Earnings or Profits
	Issue No. 1 Decided in Favor of Petitioner	Issue No. 1 Decided in Favor of Respondent
Operating deficit, March 1, 1913.....	\$4,878,987.40	\$3,729,503.27
Earnings or profits realized during the period from March 1, 1913, to March 15, 1922.....	6,830,763.76	6,830,763.76
Available for dividends.....	1,951,776.36	3,101,260.49
Dividend paid, March 15, 1922.....	500,000.00	500,000.00
Balance, March 15, 1922.....	1,451,776.36	2,601,260.49
Earnings or profits, March 16 to June 30, 1922.....	82,850.29	82,850.29
Available for dividends.....	1,534,626.65	2,684,110.78
Dividend paid, June 30, 1922.....	200,000.00	200,000.00
Balance, June 30, 1922.....	1,334,626.65	2,484,110.78
Earnings or profits, July 1, 1922, to December 22, 1924..	448,859.89	448,859.89

Available for dividends.....	1,783,486.54			6,662,473.94	6,662,473.94
Dividend paid, December 22, 1924.....	650,000.00			650,000.00	650,000.00
Balance, December 22, 1924.....	1,133,486.54			6,012,473.94	6,012,473.94
Earnings or profits, December 23, 1924, to May 22, 1926..	201,191.03			201,191.03	201,191.03
Available for dividends.....	1,334,677.57			6,213,664.97	6,213,664.97
Dividend paid, May 22, 1926.....	1,558,319.04			1,558,319.04	1,558,319.04
Proportion of May 22, 1926, dividend which was from capital.....	223,641.47		None	None	None
Accumulated earnings or profits, May 22, 1926.....	None		925,842.66	4,655,345.93	4,655,345.93
Earnings or profits, May 23, 1926, to November 18, 1936..	511,627.09		511,627.09	511,627.09	511,627.09
Accumulated earnings or profits, November 18, 1936, transferred to J. D. and A. B. Spreckels Company upon liquidation.....	\$ 511,627.09		\$1,437,469.75	\$5,166,973.02	\$5,166,973.02

(17) Prior to March 1, 1913, J. D. and A. B. Spreckels Company and its predecessor in interest owned, and at all times since said date have owned, substantial amounts of the capital stock of Kilauea Sugar Plantation Company and have received dividends therefrom. The following schedule shows the operating deficit of Kelauea Sugar Plantation Company as of March 1, 1913; the earnings or profits of said company realized subsequent thereto; and the dividends declared and paid subsequent to December 31, 1915, which are the only dividends herein material. All of said figures are shown in two columns, the first column showing the result if petitioners are correct in their contention that said operating deficit as of March 1, 1913, must be made up from subsequent earnings or profits before earnings or profits are available for dividends, and the second column showing the result if the respondent is correct in his contention that said operating deficie need not be made up from subsequent earnings or profits:

Kilauea Sugar Plantation Company

Kilauea Sugar Plantation Company	March 1, 1913 Operating Deficit Made Up From Subsequent Earnings or Profits		March 1, 1913 Operating Deficit Not Made Up From Subsequent Earnings or Profits	
	Earned Surplus or (Deficit)	Dividends From Capital	Earned Surplus or (Deficit)	Dividends From Capital
Operating (deficit), March 1, 1913.....	\$(308,429.18)		\$(308,429.18)	
Undistributed earnings or profits, March 1, 1913, to December 31, 1916.....	127,381.81		127,381.81	
Available for dividends (operating deficit).....	(181,047.37)		127,381.81	
Dividends paid, 1916—\$120,000 .....	.....	\$120,000.00	120,000.00	
Balance, December 31, 1916 (operating deficit).....	(181,047.37)		7,381.81	
Earnings or profits, January 1 to January 2, 1917.....	449.76		449.76	
Available for dividends (operating deficit).....	(180,597.61)		7,831.57	
Dividend paid, January 2, 1917—\$10,000 .....	.....	10,000.00	10,000.00	\$ 2,168.43
Balance, January 2, 1917 (operating deficit).....	(180,597.61)		None	
Earnings or profits, January 3 to December 31, 1917.....	81,632.08		81,632.08	
Available for dividends (operating deficit).....	(98,965.53)		81,632.08	
Dividend paid, December 31, 1917—\$40,000 .....	.....	40,000.00	40,000.00	
Balance, December 31, 1917 (operating deficit).....	(98,965.53)		41,632.08	

Earnings and profits, January 1 to October 1, 1918.....	21,124.09	21,124.09
Available for dividends (operating deficit).....	(77,841.44)	62,756.17
Dividend paid, October 1, 1918—\$100,000.....	.....	100,000.00
		37,243.83
Balance, October 1, 1918 (operating deficit).....	(77,841.44)	None
Earnings or profits, Oct. 2, 1918, to Dec. 31, 1921.....	388,943.37	388,943.37
Available for dividends	311,101.93	388,943.37
Dividends paid, 1921—\$90,000.....	90,000.00	90,000.00
Balance, December 31, 1921.....	221,101.93	298,943.37
(Operating deficits), Jan. 1, 1922 to June 24, 1931.....	(376,553.68)	(376,553.68)
Dividend paid, June 24, 1931—\$100,000.....	(155,451.75)	(77,610.31)
	.....	100,000.00
Balance, June 24, 1931 (operating deficit).....	(155,451.75)	(77,610.31)
Earnings or profits, June 25, 1931, to Dec. 31, 1935.....	190,439.49	190,439.49
Balance, December 31, 1935.....	34,987.74	112,829.18
Earnings or profits, year 1936.....	38,671.17	38,671.17
Dividend paid, 1936	73,658.91	151,500.35
	40,000.00	40,000.00
Balance, December 31, 1936.....\$	33,658.91	\$111,500.35
Dividends from capital.....		
	\$370,000.00	\$139,412.26

Note: No dividends were paid during the years 1937 to 1940. inclusive.

(18) The dividends received by J. D. and A. B. Spreckels Company and its predecessor in interest from Kilauea Sugar Plantation Company and the portion thereof which was paid out of earnings or profits in accordance with the foregoing schedule are as follows:

	Dividends Paid by Kilauea	Dividends Received by J. D. and A. B. Spreckels Co. and Its Predecessor in Interest	From Earnings or Profits	
			March 1, 1913, Operating Deficit Made Up From Subsequent Earnings or Profits	March 1, 1913, Operating Deficit Not Made Up From Subsequent Earnings or Profits
1916.....	\$120,000	\$ 65,934.00	.....	\$ 65,934.00
1917.....	50,000	27,472.50	.....	26,281.06
1918.....	100,000	54,945.00	.....	34,481.38
1921.....	90,000	49,450.50	\$49,450.50	49,450.50
1931.....	100,000	54,945.00	.....	.....
1936.....	40,000	21,978.00	21,978.00	21,978.00
	<u>\$500,000</u>	<u>\$274,725.00</u>	<u>\$71,428.50</u>	<u>\$198,124.94</u>

III.

Facts relating to issue numbered (3) above

(19) Seventh and Hill Building Corporation was a wholly-owned subsidiary of J. D. and A. B. Spreckels Company and on December 13, 1938, said Seventh and Hill Building Corporation transferred all its assets to J. D. and A. B. Spreckels Company in complete liquidation within the meaning of Section 112 (b)(6) of the Revenue Act of 1938. On that date said corporation had an operating deficit accumulated since March 1, 1913, in the amount of \$98,594.01.

(20) Monterey County Water Company was a wholly-owned susidiary of J. D. and A. B. Spreckels Company and on November 18, 1936, said Monterey County Water Company transferred all its assets to J. D. and A. B. Spreckels Company, in complete liquidation within the meaning of Section 112 (b) (6) of the Revenue Act of 1936. On that date said corporation had an operating deficit accumulated since March 1, 1913, in the amount of \$47,030.64.

(21) The question for decision by the court is whether said operating deficits of said wholly-owned subsidiaries were transferred to the parent company, J. D. and A. B. Spreckels Company, upon the liquidation of said subsidiaries.

(22) The parties hereto have agreed that, depending upon the decision of the court with respect to the foregoing issues, the earnings or profits of J. D. and A. B. Spreckels Company available for dividends in each of the years 1938, 1939 and 1940, the dividends paid in each of said years, and the portion thereof paid out of earnings or profits are as follows:

1. In the event all the foregoing issues are decided in favor of petitioner, the earnings or profits available for dividends in each of the years 1938, 1939 and 1940, the dividends paid in each of said years, and the portion thereof paid out of earnings or profits are as follows:

	Earnings or Profits	Dividends From Earnings or Profits	Dividends From Capital
Accumulated earnings or profits, January 1, 1938.....	\$1,990,621.89		
(Operating deficit) January 1, 1938, to December 14, 1938.....	(1,163,634.05)		
(Operating deficit) of Seventh and Hill Building Corporation at date of liquidation, December 13, 1938.....	(98,594.01)		
Available for dividends	728,393.83		
Dividends paid, January 1 to December 15, 1938—\$600,000.....	600,000.00	\$ 600,000.00	None
Balance, December 15, 1938.....	128,393.83		
(Operating deficit) December 15, 1938, to December 21, 1938.....	(23,406.43)		
Available for dividends	104,987.40		
Dividend paid, December 22, 1938—\$250,000.....	104,987.40	104,987.40	\$ 145,012.60
Balance, December 22, 1938.....	None		
(Operating deficit) December 22, 1938, to December 31, 1938.....	(33,437.76)		
Balance, December 31, 1938 (operating deficit).....	(33,437.76)		
Earnings or profits, year 1939, available for dividends.....	604,432.80		
Dividends paid, year 1939—\$1,100,000.....	604,432.80	604,432.80	495,567.20

Balance, December 31, 1939 (operating deficit).....	(33,437.76)		
Earnings or profits, year 1940, available for dividends.....	304,193.21		
Dividends paid, year 1940—\$1,360,000.....	304,193.21	304,193.21	1,055,806.79
Balance, December 31, 1940 (operating deficit).....	(33,437.76)		
Total dividends for the years 1938 to 1940, inclusive.....	\$3,310,000.00	\$1,613,613.41	\$1,696,386.59

2. In the event the first and second of the foregoing issues are decided in favor of petitioner and the third issue is decided in favor of respondent, the earnings or profits available for dividends in each of the years 1938, 1939 and 1940, the dividends paid in each of said years, and the portion thereof paid out of earnings or profits are as follows:

	Earnings or Profits	Dividends From Earnings or Profits	Dividends From Capital
Accumulated earnings or profits, January 1, 1938.....	\$2,037,652.53		
(Operating deficit) January 1, 1938, to December 14, 1938.....	(1,163,634.05)		
(Operating deficit) of Seventh and Hill Building Corporation at date of liquidation, December 13, 1938.....	None		
Available for dividends	874,018.48		
Dividends paid, January 1 to December 15, 1938—\$600,000.....	600,000.00	\$ 600,000.00	None
Balance, December 15, 1938.....	274,018.48		
(Operating deficit) December 15, 1938, to December 21, 1938.....	(23,406.43)		
Available for dividends	250,612.05		
Dividend paid, December 22, 1938—\$250,000.....	250,000.00	250,000.00	None
Balance, December 22, 1938.....	612.05		
(Operating deficit) December 22, 1938, to December 31, 1938.....	(33,437.76)		
Balance, December 31, 1938 (operating deficit).....	(32,825.71)		
Earnings or profits, year 1939, available for dividends.....	604,432.80		

Dividends paid, year 1939—\$1,100,000.....	604,432.80	604,432.80	\$ 495,567.20
Balance, December 31, 1939 (operating deficit).....	(32,825.71)		
Earnings or profits, year 1940, available for dividends.....	304,193.21		
Dividends paid, year 1940—\$1,360,000.....	304,193.21	304,193.21	1,055,806.79
Balance, December 31, 1940 (operating deficit).....	(32,825.71)		
Total dividends for the years 1938 to 1940, inclusive.....	\$3,310,000.00	\$1,758,626.01	\$1,551,373.99

3. In the event the first and third of the foregoing issues are decided in favor of petitioner and the second issue is decided in favor of respondent, the earnings or profits available for dividends in each of the years 1938, 1939 and 1940, the dividends paid in each of said years, and the portion thereof paid out of earnings or profits are as follows:

	Earnings or Profits	Dividends From Earnings or Profits	Dividends From Capital
Accumulated earnings or profits, January 1, 1938.....	\$6,728,579.54		
(Operating deficit) January 1, 1938, to December 14, 1938.....	(1,163,634.05)		
(Operating deficit) of Seventh and Hill Building Corporation at date of liquidation, December 13, 1938.....	(98,594.01)		
Available for dividends	5,466,351.48		
Dividends paid, January 1 to December 15, 1938—\$600,000.....	600,000.00	600,000.00	None
Balance, December 15, 1938.....	4,866,351.48		
(Operating deficit) December 15, 1938, to December 21, 1938.....	(23,406.43)		
Available for dividends	4,842,945.05		
Dividend paid, December 22, 1938—\$250,000.....	250,000.00	250,000.00	None
Balance, December 22, 1938.....	4,592,945.05		
(Operating deficit) December 22, 1938, to December 31, 1938.....	(33,437.76)		
Balance, December 31, 1938	4,559,507.29		

Earnings or profits, year 1939.....	604,432.80	
Available for dividends	5,163,940.09	
Dividends paid, year 1939—\$1,100,000.....	1,100,000.00	None
Balance, December 31, 1939	4,063,940.09	
Earnings or profits, year 1940.....	304,193.21	
Available for dividends	4,368,133.30	
Dividends paid, year 1940—\$1,360,000.....	1,360,000.00	None
Balance, December 31, 1940.....	3,008,133.30	
Total dividends for the years 1938 to 1940, inclusive.....	\$3,310,000.00	None

4. In the event of the second and third of the foregoing issues are decided in favor of petitioner and the first issue is decided in favor of respondent, the earnings or profits available for dividends in each of the years 1938, 1939 and 1940, the dividends paid in each of said years, and the portion thereof paid out of earnings or profits are as follows:

	Earnings or Profits	Dividends From Earnings or Profits	Dividends From Capital
Accumulated earnings or profits, January 1, 1938.....	\$2,969,313.32		
(Operating deficit) January 1, 1938, to December 14, 1938.....	(1,163,634.05)		
(Operating deficit) of Seventh and Hill Building Corporation at date of liquidation, December 13, 1938.....	(98,594.01)		
Available for dividends	1,707,085.26		
Dividends paid, January 1 to December 15, 1938—\$600,000.....	600,000.00	\$ 600,000.00	None
Balance, December 15, 1938.....	1,107,085.26		
(Operating deficit) December 15, 1938, to December 21, 1938.....	(23,406.43)		
Available for dividends	1,083,678.83		
Dividend paid, December 22, 1938—\$250,000.....	250,000.00	250,000.00	None
Balance, December 22, 1938.....	833,678.83		
(Operating deficit) December 22, 1938, to December 31, 1938.....	(33,437.76)		
Balance, December 31, 1938.....	800,241.07		

Earnings or profits, year 1939.....	604,432.80		
Available for dividends	1,404,673.87		
Dividends paid, year 1939—\$1,100,000.....	1,100,000.00	1,100,000.00	None
Balance, December 31, 1939.....	304,673.87		
Earnings or profits, year 1940.....	304,193.21		
Available for dividends	608,867.08		
Dividends paid, year 1940—\$1,360,000.....	608,867.08	608,867.08	\$ 751,132.92
Balance, December 31, 1940.....	None		
Total dividends for the years 1938 to 1940, inclusive.....	<u>\$3,310,000.00</u>	<u>\$2,558,867.08</u>	<u>\$ 751,132.92</u>

i. In the event the first of the foregoing issues is decided in favor of petitioner and the second and third issues are decided in favor of respondent, the earnings or profits available for dividends in each of the years 1938, 1939 and 1940, the dividends paid in each of said years, and the portion thereof paid out of earnings or profits are as follows:

	Earnings or Profits	Dividends From Earnings or Profits	Dividends From Capital
Accumulated earnings or profits, January 1, 1938.....	\$6,775,610.18		
(Operating deficit) January 1, 1938, to December 14, 1938.....	(1,163,634.05)		
(Operating deficit) of Seventh and Hill Building Corporation at date of liquidation, December 13, 1938.....	None		
Available for dividends	5,611,976.13		
Dividends paid, January 1 to December 15, 1938—\$600,000.....	600,000.00	\$ 600,000.00	None
Balance, December 15, 1938.....	5,011,976.13		
(Operating deficit) December 15, 1938, to December 21, 1938.....	(23,406.43)		
Available for dividends	4,988,569.70		
Dividend paid, December 22, 1938—\$250,000.....	250,000.00	250,000.00	None
Balance, December 22, 1938.....	4,738,569.70		
(Operating deficit) December 22, 1938, to December 31, 1938.....	(33,437.76)		
Balance, December 31, 1938.....	4,705,131.94		

Earnings or profits, year 1939.....	604,432.80	
Available for dividends	<u>5,309,564.74</u>	
Dividends paid, year 1939—\$1,100,000.....	1,100,000.00	None
Balance, December 31, 1939.....	<u>4,209,564.74</u>	
Earnings or profits, year 1940.....	304,193.21	
Available for dividends	<u>4,513,757.95</u>	
Dividends paid, year 1940—\$1,360,000.....	1,360,000.00	None
Balance, December 31, 1940.....	<u>3,153,757.95</u>	
Total dividends for the years 1938 to 1940, inclusive.....	<u><u>\$3,310,000.00</u></u>	None

6. In the event the third of the foregoing issues is decided in favor of petitioner and the first and second issues are decided in favor of respondent, the earnings or profits available for dividends in each of the years 1938, 1939 and 1940, the dividends paid in each of said years, and the portion thereof paid out of earnings or profits are as follows:

	Earnings or Profits	Dividends From Earnings or Profits	Dividends From Capital
Accumulated earnings or profits, January 1, 1938.....	\$6,728,579.54		
(Operating deficit) January 1, 1938, to December 14, 1938.....	(1,163,634.05)		
(Operating deficit) of Seventh and Hill Building Corporation at date of liquidation, December 13, 1938.....	(98,594.01)		
Available for dividends	5,466,351.48		
Dividends paid, January 1 to December 15, 1938—\$600,000.....	600,000.00	\$ 600,000.00	None
Balance, December 15, 1938.....	4,866,351.48		
(Operating deficit) December 15, 1938, to December 21, 1938.....	(23,406.43)		
Available for dividends	4,842,945.05		
Dividend paid, December 22, 1938—\$250,000.....	250,000.00	250,000.00	None
Balance, December 22, 1938.....	4,592,945.05		
(Operating deficit) December 22, 1938, to December 31, 1938.....	(33,437.76)		
Balance, December 31, 1938.....	4,559,507.29		

Earnings or profits, year 1939.....	604,432.80	
Available for dividends	<u>5,163,940.09</u>	
Dividends paid, year 1939—\$1,100,000.....	1,100,000.00	None
Balance, December 31, 1939.....	<u>4,063,940.09</u>	
Earnings or profits, year 1940.....	304,193.21	
Available for dividends	<u>4,368,133.30</u>	
Dividends paid, year 1940—\$1,360,000.....	1,360,000.00	None
Balance, December 31, 1940.....	<u>3,008,133.30</u>	
Total dividends for the years 1938 to 1940, inclusive.....	<u><u>\$3,310,000.00</u></u>	None

7. In the event the second of the foregoing issues is decided in favor of petitioner and the first and third issues are decided in favor of respondent, the earnings or profits available for dividends in each of the years 1938, 1939 and 1940, the dividends paid in each of said years, and the portion thereof paid out of earnings or profits are as follows:

	Earnings or Profits	Dividends From Earnings or Profits	Dividends From Capital
Accumulated earnings or profits, January 1, 1938.....	\$3,016,343.96		
(Operating deficit) January 1, 1938, to December 14, 1938.....	(1,163,634.05)		
(Operating deficit) of Seventh and Hill Building Corporation at date of liquidation, December 13, 1938.....	None		
Available for dividends	1,852,709.91		
Dividends paid, January 1 to December 15, 1938—\$600,000.....	600,000.00	\$ 600,000.00	None
Balance, December 15, 1938.....	1,252,709.91		
(Operating deficit) December 15, 1938, to December 21, 1938.....	(23,406.43)		
Available for dividends	1,229,303.48		
Dividend paid, December 22, 1938—\$250,000.....	250,000.00	250,000.00	None
Balance, December 22, 1938.....	979,303.48		
(Operating deficit) December 22, 1938, to December 31, 1938.....	(33,437.76)		
Balance, December 31, 1938.....	945,865.72		

Earnings or profits, year 1939.....	604,432.80		
Available for dividends	1,550,298.52		
Dividends paid, year 1939—\$1,100,000.....	1,100,000.00	1,100,000.00	None
Balance, December 31, 1939.....	450,298.52		
Earnings or profits, year 1940.....	304,193.21		
Available for dividends	754,491.73		
Dividends paid, year 1940—\$1,360,000.....	754,491.73	754,491.73	\$ 605,508.27
Balance, December 31, 1940.....	None		
Total dividends for the years 1938 to 1940, inclusive.....	\$3,310,000.00	\$2,704,491.73	\$ 605,508.27

8. In the event all the foregoing issues are decided in favor of respondent, the earnings or profits available for dividends in each of the years 1938, 1939 and 1940, the dividends paid in each of said years, and the portion thereof paid out of earnings or profits are as follows:

	Earnings or Profits	Dividends From Earnings or Profits	Dividends From Capital
Accumulated earnings or profits, January 1, 1938.....	\$6,775,610.18		
(Operating deficit) January 1, 1938, to December 14, 1938.....	(1,163,634.05)		
(Operating deficit) of Seventh and Hill Building Corporation at date of liquidation, December 13, 1938.....	None		
Available for dividends	5,611,976.13		
Dividends paid, January 1 to December 15, 1938—\$600,000.....	600,000.00	\$ 600,000.00	None
Balance, December 15, 1938.....	5,011,976.13		
(Operating deficit) December 15, 1938, to December 21, 1938.....	(23,406.43)		
Available for dividends	4,988,569.70		
Dividend paid, December 22, 1938—\$250,000.....	250,000.00	250,000.00	None
Balance, December 22, 1938.....	4,738,569.70		
(Operating deficit) December 22, 1938, to December 31, 1938.....	(33,437.76)		
Balance, December 31, 1938.....	4,705,131.94		

Earnings or profits, year 1939.....	604,432.80	
Available for dividends	5,309,564.74	
Dividends paid, year 1939—\$1,100,000.....	1,100,000.00	None
Balance, December 31, 1939.....	4,209,564.74	
Earnings or profits, year 1940.....	304,193.21	
Available for dividends	4,513,757.95	
Dividends paid, year 1940—\$1,360,000.....	1,360,000.00	None
Balance, December 31, 1940.....	3,153,757.95	
Total dividends for the years 1938 to 1940, inclusive.....	\$3,310,000.00	None

(23) The maximum portion of the dividends declared by J. D. and A. B. Spreckels Company during the years 1938, 1939 and 1940 which was paid out of capital, as shown by the foregoing eight schedules, is \$1,696,386.59, the amount shown by Schedule 1. During each of the years 1938, 1939 and 1940 J. D. and A. B. Spreckels Company had 20,000 shares of capital stock outstanding. The maximum possible capital distribution per share during said three years is therefore approximately \$84.82 and it is agreed between the parties hereto that the basis of each and every share of stock to each of the petitioners herein is in excess of said amount.

Dated this 29th day of October, 1947.

/s/ LEON de FREMERY,
Attorney for Petitioners.

/s/ CHARLES OLIPHANT,
Chief Counsel, Bureau of
Internal Revenue.

EXHIBIT 1-A

Excerpt From Minutes of Meeting of Board of
Directors of J. D. Spreckels and Bros. Co.
Held on November 15, 1912

On motion of Director A. B. Spreckels, seconded
by Director F. S. Samuels, the following Preambles
and Resolution were unanimously adopted.

Whereas: This Company holds the following
promissory notes of the Oceanic Steamship Com-
pany, to wit:

June 4, 1910, promissory note for.....	\$ 784,972.23
Dec. 20, 1910, promissory note for.....	344,583.33
Dec. 26, 1911, promissory note for.....	74,514.92

Making a Total of.....\$1,204,070.48

Whereas: Said notes are long past due and
neither principal nor interest thereof has been paid,
but this Company has, from time to time, charged
to the over-draft account of said Oceanic Steamship
Company the accrued interest thereon and has been
required to take the promissory note of said Oceanic
Steamship Company in discharge thereof; and

Whereas: There exists in the treasury of said
Oceanic Steamship Company twenty-three thousand
six hundred and forty-seven (23,647) shares of its
capital stock which the officers of said Company
signify their willingness to transfer to this Com-
pany, in consideration of the cancellation and re-
turn of said Notes.

Now, Therefore Be It Resolved, that the Secre-
tary of this Company be, and he is hereby author-

ized and directed to offer to cancel and return said notes, together with accrued interest thereon, of said Oceanic Steamship Company to said Oceanic Steamship Company, in consideration of the issuance and delivery to this Company of said twenty-three thousand, six hundred and forty-seven (23,647) shares of the capital stock of said Oceanic Steamship Company, and upon receipt of certificates representing said capital stock, so to be issued and delivered as aforesaid, the Secretary of this Company is authorized and directed to so cancel said notes, together with accrued interest thereon, and return the same to the said Oceanic Steamship Company.

EXHIBIT 2-B

Excerpt From Minutes of Meeting of Board of
Directors of Oceanic Steamship Company Held
on November 16, 1912

Director W. D. K. Gibson, Secretary of J. D. Spreckels and Bros. Company, a corporation, read to the meeting a communication in words and figures following, to wit:

“San Francisco, Cal., November 16, 1912
Oceanic Steamship Company,
100 Davis Street,
San Francisco, Cal.
Gentlemen:

I am authorized, by resolution of the Board of Directors of J. D. Spreckels & Bros. Company, to offer to purchase from your Company, 23,647 shares

of its Capital Stock, in consideration of the acceptance by your Company, as payment therefor, of the amounts now due from your Company to J. D. Spreckels & Bros. Company, together with interest thereon, as evidenced by those certain promissory notes heretofore issued by your Company in favor of J. D. Spreckels & Bros. Company, as follows:

June 4, 1910, promissory note for.....	\$ 784,972.23
Dec. 20, 1910, promissory note for.....	344,583.33
Dec. 26, 1911, promissory note for.....	74,514.92

Making a total principal sum of...\$1,204,070.48

Which Promissory Notes and accrued interest I am authorized to cancel and return to you upon receipt of appropriate certificates issued in the name of J. D. Spreckels and Bros. Company for said 23,647 shares of the Capital Stock of your Company.

Yours truly,

J. D. SPRECKELS & BROS.
COMPANY,

[Seal] By /s/ W. D. K. GIBSON,
Secretary.

After a discussion of the above communication on motion of Director A. B. Spreckels, seconded by Director Bourdette, which motion was duly put, seconded and carried, the following Resolution was unanimously adopted:

“Resolved: That the offer of J. D. Spreckels & Bros. Company, a corporation, to cancel the bills payable of this Company, of the following amounts and dates, to wit:

June 4, 1910, promissory note for.....	\$ 784,972.23
Dec. 20, 1910, promissory note for.....	344,583.33
Dec. 26, 1911, promissory note for.....	74,514.92

Making a total principal sum of...\$1,204,070.48

together with accrued interest thereon, in consideration of the sale and transfer by this Company to said J. D. Spreckels and Bros. Company, a corporation, of 23,647 shares of the Capital Stock of this Company, which now is in the Treasury of this Company, be, and the same is hereby accepted, and the President and Secretary of this Company are hereby authorized and directed to issue and deliver such stock to said J. D. Spreckels & Bros. Company, a corporation, upon receipt of said above bills payable properly cancelled, together with the cancellation of accrued interest on said above bills payable.”

EXHIBIT 3-C

Oceanic Steamship Company
(a California corporation)

Balance Sheets Per Books
As of October 31, 1912, and December 31, 1912

	Oct. 31, 1912	Dec. 31, 1912
Assets:		
Cash	\$ 328.43	\$ 343.78
Accounts receivable	39,207.32	41,810.78
Store and supplies	5,131.76	5,001.75
Vessels, equipment, furniture and fixtures	3,696,092.77	2,110,029.81
Deferred charges	5,374.04	16,670.08
Total assets	<u>\$3,746,134.32</u>	<u>\$2,173,856.20</u>
Liabilities:		
Account payable, J. D. Spreckels & Bros. Company	\$ 584,978.20	\$ 495,769.11
Accrued interest on bonds	270,450.00	360,600.00
Notes payable, J. D. Spreckels & Bros. Company	1,204,070.48	.....
Accrued interest on notes payable..	79,623.91	.....
Other .....	.....	5,325.49
	<u>2,139,122.59</u>	<u>861,694.60</u>
First mortgage bonds	1,803,000.00	1,803,000.00
Total liabilities	<u>\$3,942,122.59</u>	<u>\$2,664,694.60</u>
Capital:		
Capital stock outstanding, 50,000 shares, par \$100	\$5,000,000.00	\$5,000,000.00
(Deduct):		
Treasury stock account	(134,210.26)	.....
Stock bonus account	(973,500.00)	.....
Deficit	(4,088,278.01)	(5,490,838.40)
Total capital (deficiency)	<u>(195,988.27)</u>	<u>(490,838.40)</u>
Total liabilities & capital	<u>\$3,746,134.32</u>	<u>\$2,173,856.20</u>

Filed at hearing Nov. 3, 1947, T.C.U.S.

[Title of Tax Court and Cause.]

Docket No. 5333

SUPPLEMENTARY STIPULATION OF FACTS

It Is Hereby Stipulated and Agreed by and between the parties hereto, by their respective attorneys, that the following facts shall be taken as true upon the trial of the above-entitled case, provided, however, that this stipulation shall be without prejudice to the right of either party to introduce other and further evidence not inconsistent with the facts herein stipulated to be taken as true.

1. It is agreed that during the calendar year 1940 petitioner paid the sum of \$5,273.73 as interest and that said sum is allowable in full as a deduction in computing petitioner's taxable income for said year.

2. Petitioner at all times during the calendar year 1940 was the owner of 6 shares of stock of J. D. and A. B. Spreckels Company issued to and standing in her name, and voting trust certificates representing 972 shares of the capital stock of said company. Petitioner received from said company distributions on said shares in the following amount:

Schedule A			
Year	From Shares Standing in Her Own Name	From Shares Covered by Said Voting Trust Certificates	Total
1940.....	\$408.00	\$66,096.00	\$66,504.00

At all times during the calendar year 1940 petitioner was a beneficiary of a trust known as the Grace S. Hamilton Trust, Crocker First National

Bank of San Francisco, et al., Trustees, and as such beneficiary was entitled to receive one-half of the income of said trust for said year. Included in the assets of said trust for said year were voting trust certificates representing 1,340 shares of the capital stock of J. D. and A. B. Spreckels Company. The distributions received by the trustees from said company were, under the terms of the trust, after deducting certain prior charges and expenses of the trust, currently distributable to the beneficiary. During said year 1940 the trustees made distributions as required by the terms of the trust and petitioner received from the trustees as petitioner's net share of the said distributions of J. D. and A. B. Spreckels Company on said 1,340 shares the following amount:

Schedule B			
		J. D. and A. B.	
Year	Net Distribution by Trustees	Spreckels Company Dividends	Net Bal. of Other Items
1940.....	\$47,695.81	\$45,560.00	\$2,135.81

The parties are agreed that the portion of the dividends of J. D. and A. B. Spreckels Company for the year 1940 which this Court determines in this case of Grace H. Kelham, Petitioner vs. Commissioner of Internal Revenue, Respondent, Docket No. 5333, have been paid out of capital will represent: (a) The portion of the amount listed in the "Total" column of Schedule A which is to be subtracted from petitioner's taxable income for the year 1940; and (b) the portion of the amount listed in the column entitled "J. D. and A. B. Spreckels Company Dividends" of Schedule B which is to

be subtracted from the amount listed in the column entitled "Net Distribution by Trustees" of Schedule B in determining petitioner's taxable income for the year 1940.

Dated this 31st day of October, 1947.

/s/ LEON de FREMERY,
Attorney for Petitioner.

/s/ CHARLES OLIPHANT,
Chief Counsel, Bureau of
Internal Revenue.

Filed at hearing Nov. 3, 1947, T.C.U.S.

The Tax Court of the United States

Docket No. 5333

GRACE H. KELHAM,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Docket No. 5334

LEILA H. NEILL,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Docket No. 5495

ELLIS M. MOORE,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Docket No. 5559

HARRIET H. BELCHER,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Docket No. 5560

LILLIE S. WEGEFORTH,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Promulgated December 20, 1949.

In determining earnings or profits accumulated after February 28, 1913, held that capital impaired by pre-March 1, 1913, operating losses must be restored out of subsequent earnings or profits.

Where shares of a corporation are forfeited or "bid" in for the amount of unpaid assessments or calls thereon and after being carried on the books

of the corporation as treasury shares for some years and, at a time when the corporate capital stands impaired from operating losses, are issued in consideration for the cancellation of notes of the corporation which had been given to cover advances to the corporation and accrued interest thereon, held that such issue or disposition of the treasury shares was in character a capital-producing transaction and did not result in a restoration of impaired capital through realization of profits.

Two wholly-owned subsidiary corporations having capital impaired by operating losses sustained after February 28, 1913, were dissolved in liquidations falling within section 112 (b)(6) of the Revenue Acts of 1936 and 1938. Held, that the earnings or profits of the parent corporation are not absorbed by such impairment of the capital of the dissolved subsidiaries in computing the accumulated earnings or profits of the parent corporation available for distribution as taxable dividends. *Commissioner v. Phipps*, 336 U. S. 410, followed.

LEON de FREMERY, ESQ.,

For the petitioners.

W. J. McFARLAND, ESQ., and

T. M. MATHER, ESQ.,

For the respondent.

OPINION

Turner, Judge:

The respondent has determined deficiencies in income tax against the petitioners as follows:

Petitioner	Docket No.	1937	1938	1939	1940
Grace H. Kelham.....	5333	-----	-----	-----	\$48,658.15
Leila H. Neill.....	5334	-----	\$2,990.24	\$ 242.05	46,762.19
Ellis M. Moore.....	5495	\$6,989.38	3,274.99	2,744.62	23,499.16
Harriet H. Belcher.....	5559	-----	-----	-----	1,471.00
Lillie S. Wegeforth.....	5560	-----	711.19	1,069.75	80,032.58

Overpayments are claimed as follows:

Petitioner	1937	1938	1939
Leila H. Neill.....	-----	\$ 6,703.76	\$13,975.37
Ellis M. Moore.....	\$10,436.63	5,723.26	7,324.66
Lillie S. Wegeforth	-----	15,578.82	32,427.63

The petitioners, during the years 1938 through 1940, were stockholders of J. D. and A. B. Spreckels Company, hereinafter referred to as the Spreckels Company. During those years, Spreckels Company made distributions to its stockholders. The respondent has determined that those distributions, in full, were taxable dividends within the meaning of section 115 of the applicable Revenue Acts. It is the claim of the petitioners that the distributions, in part, were distributions of capital. The facts have been stipulated.

In liquidations coming within the purview of section 112(b)(6) of the Revenue Acts of 1936 and 1938, Spreckels Company had acquired all of the assets of three wholly-owned subsidiaries. Oceanic Steamship Company, sometimes referred to herein as Oceanic, and Monterey County Water Company were so liquidated in 1936. The liquidation of Seventh and Hill Building Corporation occurred in 1938. Prior to March 1, 1913, and at all times since that date, Spreckels Company and its predecessor in interest owned substantial amounts of the capital

stock of Kilauea Sugar Plantation Company, sometimes referred to herein as Kilauea, and received dividends therefrom.

The parties have agreed that the extent to which the distributions made by Spreckels Company to its stockholders during the taxable years constituted taxable dividends will be determined upon the disposition of three issues. These issues as posed by stipulation of the parties, are as follows:

1. Whether the transfer by Oceanic Steamship Company on November 16, 1912, of 23,647 shares of its stock to J. D. Spreckels & Bros. Company in consideration for the cancellation and surrender by J. D. Spreckels & Bros. Company of notes payable by Oceanic Steamship Company to J. D. Spreckels & Bros. Company reduced the operating deficit of said Oceanic Steamship Company.

2. Whether the operating deficits of Oceanic Steamship Company and Kilauea Sugar Plantation Company as of March 1, 1913, must be restored by subsequent earnings or profits in determining the amount of earnings or profits available for dividends.

3. Whether the operating deficits of Seventh and Hill Building Corporation and Monterey County Water Company, wholly-owned subsidiaries of J. D. and A. B. Spreckels Company, were transferred to J. D. and A. B. Spreckels Company at the time of the liquidation of the said wholly-owned subsidiaries.

It is stipulated that at March 1, 1913, both Oceanic and Kilauea had operating deficits, the said deficit of Kilauea being \$308,429.18, while that of Oceanic is stipulated to turn on the disposition by this Court of issue numbered one, as stated above. As to Monterey County Water Company, the parties have stipulated that at the time of its liquidation, in 1936, it had an operating deficit accumulated since March 1, 1913, in the amount of \$47,030.64. As to Seventh and Hill Building Corporation, the parties have stipulated that at the time of its liquidation, in 1938, it had an operating deficit accumulated since March 1, 1913, in the amount of \$98,594.01.

From the stipulation and the briefs of the parties, it is assumed that when referring to "operating deficits" the parties mean the amounts by which the capital of the various corporations, as of the respective dates, stood impaired by reason of operating losses. Otherwise, the use of the term "operating deficit" might well leave some doubt as to the sufficiency of the facts for the purpose of determining the character of the distributions made by Spreckels Company to the petitioners, in that in certain circumstances and as of a given period, a corporation might have an operating deficit which would in no way affect the character of the corporate distributions made to stockholders. See *Helvering v. Canfield*, 291 U. S. 163, affirming 24 B. T. A. 480.

Turning first to the question stated by the parties as Issue 2, it is the contention of the petitioners that Oceanic and Kilauea could have no accumulated

earnings or profits after February 28, 1913, to pass on to the Spreckels Company, until impaired capital as of that date had been restored, and, to the extent that allowance for restoration of such impaired capital was not made by the respondent in his determination, the distributions here in question were not taxable dividends, within the meaning of section 115 of the statute. To the contrary, it is the claim of the respondent that by the provisions of section 115,¹ particularly those parts thereof which provide that the term "dividend" "means any distribution by a corporation to its shareholders * * * out of its earnings or profits accumulated after

¹Sec. 115. Distributions by Corporation.

(a) Definition of Dividend—The term "dividend" when used in this chapter * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made. * * *

(b) Source of Distributions—For the purpose of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113. * * *

February 28, 1913," and that "any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed," Congress drew a line at March 1, 1913, not only as to earnings and profits accumulated or existing on that date, but likewise as to the existing state of the corporate capital on that date. On that interpretation of the statute, he argues that in computing corporate earnings accumulated after February 28, 1913, regard is to be given only to operating results after that date, and no regard is to be given to the condition or state of the corporate capital on that date.

Speaking generally, and aside from the income tax aspects of the problem, the argument of the respondent is plainly contrary to fundamental principles of corporation law. The capital of a corporation is the fund on which a corporation is to do business. It is the fund to be utilized by it in making the profits which may be distributed to its stockholders as dividends. It is the fund on which creditors and people doing business with the corporation are entitled to rely for assurance that it is an entity of financial responsibility, and, except for instances where, pursuant to statute or the provisions of its charter, a corporation is being liquidated or its capital reduced, distributions from capital are not normally to be made to stockholders, but rather the capital is to be preserved and maintained intact for the purposes for which it was paid

in. In such circumstances, certain basic and fundamental principles of law have been evolved, to the end that dividends may "be declared only out of surplus profits,"² and further, "there cannot be surplus or net profits for the purpose of declaring a dividend, unless the total value of the assets of the corporation at the time it is proposed to declare the dividend exceed the amount of its capital stock, after deducting all expenses which have been incurred, and all losses which have been sustained. * * * In determining whether there are net profits from which dividends must be declared the capital must be regarded as a liability."² And where the capital of a corporation has been impaired or consumed through operations, it follows as a matter of fact and logic that even though subsequent operations result in profits, there can be no "surplus or net profits" in excess of the capital fund until the capital fund has been restored or made whole. And while under general corporation law it does appear that such restoration may, in some circumstances, be accomplished through appreciation in the value of assets, there is no such factor in this case.

Beginning with the Act of October 3, 1913, the first of the Federal income tax statutes enacted after ratification of the Sixteenth Amendment to the Constitution, dividends have, by specific statutory provision, always constituted gross income to an individual. The act contained no definition or

²Sections 5329 and 5335, Vol. 11, Fletcher's *Cyclopedia of the Law of Private Corporations*.

limitation of the term "dividend." In the Revenue Act of 1916, however, the term "dividend" was limited to distributions made or ordered to be made by a corporation out of its earnings or profits accumulated after February 28, 1913. In the Revenue Act of 1917, provision was made that any distributions made to the shareholders of a corporation should be deemed to have been made from the most recently accumulated undivided profits or surplus and should constitute a part of the annual income of the distributee for the year in which received: provided, however, that the provision be not construed as taxing earnings or profits accrued prior to March 1, 1913. Except for changes in phraseology, the statute remained in that form until the Revenue Act of 1936, when the provision limiting taxable dividends to distributions made by a corporation to its shareholders out of its earnings or profits accumulated after February 28, 1913, was amended to provide that taxable dividends should likewise include distributions "out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made." Such was the state of the statute during the taxable years here involved.

In due course, after the enactment of the Act of October 3, 1913, the Supreme Court had before it, in *Lynch v. Hornby*, 247 U. S. 339, the question whether, under the statute and the Constitution,

distributions made by a corporation to its shareholders from a surplus of corporate assets existing at March 1, 1913, were as to the stockholders taxable income. In that case, the corporation, at March 1, 1913, had surplus assets of \$3,000,000. In 1914, it made a distribution of \$650,000 to its stockholders, of which \$240,000 was from current earnings and the remaining \$410,000 was from the conversion into money of property it had owned, or in which it had had an interest, on March 1, 1913. The question was whether that portion of the distribution representing the \$410,000 was income to the stockholders. In resolving that question for the Government, the Court said:

* * * And we deem it equally clear that Congress was at liberty under the amendment to tax as income, without apportionment, everything that became income, in the ordinary sense of the word, after the adoption of the amendment, including dividends received in the ordinary course by a stockholder from a corporation, even though they were extraordinary in amount and might appear upon analysis to be a mere realization in possession of an inchoate and contingent interest that the stockholder had in a surplus of corporate assets previously existing. Dividends are the appropriate fruit of stock ownership, are commonly reckoned as income, and are expended as such by the stockholder without regard to whether they are declared from the most recent earnings, or from a surplus accumulated from the earnings of the

past, or are based upon the increased value of the property of the corporation. The stockholder is, in the ordinary case, a different entity from the corporation, and Congress was at liberty to treat the dividends as coming to him *ab extra*, and as constituting a part of his income when they came to hand.

Hence we construe the provision of the act that "the net income of a taxable person shall include gains, profits, and income derived from * * * interest, rent, dividends, * * * or gains or profits and income derived from any source whatever" as including (for the purposes of the additional tax) all dividends declared and paid in the ordinary course of business by a corporation to its stockholders after the taking effect of the act (March 1, 1913), whether from current earnings, or from the accumulated surplus made up of past earnings or increase in value of corporate assets, notwithstanding it accrued to the corporation in whole or in part prior to March 1, 1913. In short, the word "dividends" was employed in the act as descriptive of one kind of gain to the individual stockholder; dividends being treated as the tangible and recurrent returns upon his stock, analogous to the interest and rent received upon other forms of invested capital.

After concluding, as shown above, that the term "dividend" was to be given its usual and ordinary meaning, the Court took note of the fact that Con-

gress, in the Revenue Act of 1916, had limited the term to mean distributions made by a corporation out of its earnings or profits accumulated since February 28, 1913, and indicated that it regarded the amendment merely as a concession to the equity of stockholders with respect to distributions from earnings accumulated at March 1, 1913, and as to which stockholders had no constitutional immunity, rather than as being otherwise declaratory of the meaning of the term "dividend." Certainly, as a general matter, a stockholder may not be regarded as having an equity in the impairment of corporate capital so as to be entitled to distributions from corporate earnings before capital has been restored.

As to the impairment of capital or paid-in surplus accruing after February 28, 1913, as a result of operating losses, the law is well settled, and the respondent concedes, that capital must be restored to the extent of such impairment out of earnings or profits before there can be any accumulation of earnings or profits after February 28, 1913, for distribution as a taxable dividend. *Foley Securities Corporation*, 38 B. T. A. 1036, *affd.*, 106 Fed. (2d) 731; *Commissioner v. W. S. Farish & Co.*, 104 Fed. (2d) 833; *Hadden v. Commissioner*, 49 Fed. (2d) 709; *Roy J. Kinnear*, 36 B. T. A. 153, *Petition for Review dismissed*, 95 Fed. (2d) 997; *Loren D. Sale*, 35 B. T. A. 938; and *Arthur C. Stifel*, 29 B. T. A. 1145. Turning to the opinions in these cases, it seems to us plain and clear that the reasoning back of the conclusion that post-February 28, 1913, impairments of capital must be restored out of the

earnings or profits before there can be any accumulation of earnings or profits from which taxable dividends can be paid, equally demonstrates and shows that there can be no accumulation of post-February 28, 1913, profits, for the purpose of distributing taxable dividends, until impaired capital at March 1, 1913, has been restored.

In *Commissioner v. W. S. Farish & Co.*, *supra*, the court said: "It is well settled that impairment of capital or paid in surplus of a corporation which resulted from operating losses must be restored before any earnings can be available for distribution to the stockholders. *Willcuts v. Milton Dairy Co.*, 275 U. S. 215." In *Milton Dairy Co.*, the Supreme Court, while dealing with the question of the existence of undivided profits, for invested capital purposes, nevertheless very plainly disclosed its views as to the existence not only of undivided profits, but of surplus profits available for distribution as a dividend, wherein it said: "But it is a prerequisite to the existence of 'undivided profits' as well as a 'surplus' that the net assets of the corporation exceed the capital stock. Hence, where the capital is impaired, profits, though earned and remaining in the business, if insufficient to offset this impairment do not constitute 'undivided profits.' * * *

We do not think Congress intended that a corporation whose capital was impaired should be entitled to treat profits that, though earned, were insufficient to make good the impairment and create a surplus, as 'undivided profits.' "

In *Loren D. Sale*, *supra*, we had occasion to consider the question of impairment of capital occurring after February 28, 1913, and in concluding that capital must be restored to the extent of such impairment before there can be any accumulation of earnings or profits available for distribution as a taxable dividend, we said:

There is a rule of law that every impairment of capital or paid-in surplus resulting from operating losses must be restored before any earnings can be available for the distribution of a taxable dividend within the meaning of section 201 (a) of the Revenue Act of 1924. *Crystal Ice Co.*, 14 B.T.A. 682; *J. L. Washburn*, 16 B.T.A. 1091; *Arthur C. Stifel*, 29 B.T.A. 1145; *Willeuts v. Milton Dairy Co.*, 275 U. S. 215. * * *

* * *

The statute does not provide that impaired capital or paid-in surplus must be restored before earnings are available for the distribution of a taxable dividend. That rule of law was laid down by the Board and the courts, which had in mind the fundamental principle that a corporation, the capital of which had been impaired by losses, can never have any accumulated earnings until its capital is restored. Corporations, of course, were well known long before March 1, 1913, the effective date of the income tax. Likewise, the concepts of capital and impairment of capital were fixed in the

law and generally understood. The provisions of the revenue acts have not changed the law in respect of capital or impairment of capital. Those acts, however, allowed for certain purposes the use of the fair market value on March 1, 1913, of property acquired prior thereto instead of the lower cost of such property. For example, in the computation of gain or loss giving rise to income or deductions, corporations could use March 1, 1913, value, regardless of what would have been the situation had they used cost as a basis. But in the determination of whether or not the capital of a particular corporation has been impaired, there is, so far as we know, on good reason or authority for using the fair market value on March 1, 1913. * * *

The respondent cites and relies upon *Hoffman v. United States* (Ct. of Clms.), 53 Fed. (2d) 282. That case, in reality, however, was a case involving the computation of distributions made after February 28, 1913, from an increase in the value of property accruing before March 1, 1913. It is true that in the course of its opinion the Court of Claims cited, with apparent approval, its previous opinion in *Blair v. United States*, 63 Ct. Cl. 193, and the *Blair* case, on its face, does seem to stand for the proposition that, under the Revenue Act of 1917, where a corporation had current earnings and made a distribution to its stockholders, such distributions constituted taxable dividends, within the meaning

of the statute, without regard to whether or not there was an impairment of capital. The Court did not seem to concern itself with the proposition whether there was impairment of capital before or after March 1, 1913, or both. In *J. L. Washburn*, 16 B.T.A. . . . , we had occasion to consider the Blair case, and, with all due respect to the Court of Claims, concluded that it did not represent sound law and declined to follow it. In *Foley Securities Corporation v. Commissioner*, *supra*, the Circuit Court of Appeals for the Eighth Circuit took note of our views as to the Blair case, and affirmed us in our conclusion, saying: "It seems to us obvious that the ruling of the Board and of the Commissioner as to what constitutes a 'dividend' under the definition of that term contained in Section 115 (a) must be accepted as correct. It follows that the distribution which was made by the taxpayer to its shareholders in 1934 was a 'dividend' only to the extent that it exceeded the operating deficit due to losses in prior years." In so holding, it is to be noted that the Circuit Court of Appeals accepted as authority in the matters the declaration of the Supreme Court in *Willeuts v. Milton Dairy Co.*, *supra*.

The case of *Chapman v. Anderson*, 11 Fed. Supp. 913, cited and relied on by the petitioners, seems to be directly in point. The respondent takes the position that the case is of no force here, in that the question involved was whether or not a book write-up in 1925 of the value of the corporate assets as of March 1, 1913, should be regarded as restoring

capital which had been impaired by pre-March 1, 1913, operating deficits, so as to render taxable dividends paid by the corporation in 1925 and 1926. While it is true that that was the particular question and the court did conclude that the write-up of the assets on the books of the corporation as of March 1, 1913, did not restore the capital impaired, the ultimate question decided was that since the March 1, 1913, impairment of capital had not been restored out of subsequent earnings, distributions made from current profits were not taxable dividends to stockholders. In so holding, the court said that "unless an operating deficit or impairment of capital has been made good out of subsequent earnings or profits, any distribution of stock is not a 'dividend' under 26 U.S.C.A., section 932." The court there likewise looked to the Supreme Court's opinion in *Willcuts v. Milton Dairy Co.* for support, and also quoted from the opinion of the Court of Appeals for the Second Circuit, in *Hadden v. Commissioner*, *supra*, as follows: "Congress did not intend that a corporation should be held to accumulate profits for one tax purpose only and not for another. No earned surplus can be accumulated until the deficit or impairment of paid-in capital has been made good. Dividends paid while there is an operating deficit should be deemed to be from capital or paid-in surplus even though there are earnings of the taxable year sufficient to pay the dividend in whole or in part."

The reasoning of the various courts in reaching the conclusion that post-February 28, 1913, impairment of capital must be restored before there can be any accumulation of profits available for distribution to stockholders as dividends, seems to us equally applicable to impairment of capital whenever suffered or sustained, and that the statutory provision providing that pre-March 1, 1913, earnings or profits may be distributed, tax free, in no way affects the general rule stated and gives no basis for any conclusion that Congress, in recognizing, as the Supreme Court stated in *Lynch v. Hornby*, *supra*, the equity of stockholders as to pre-March 1, 1913, earnings, intended to legislate with respect to restoration or non-restoration of capital which has been impaired by operating losses. This view, in our opinion, is further supported by the Supreme Court in its treatment of the problem involved in *Helvering v. Canfield*, *supra*. In that case, the corporation had accumulated earnings and profits at March 1, 1913. These earnings and profits were dissipated by subsequent operating losses. Thereafter the corporation had earnings and profits from which distributions were made to its stockholders, and the question was whether or not, under the statutory provision that distributions of pre-March 1, 1913, earnings or profits were tax free, the post-February 28, 1913, earnings and profits must first be applied to absorb the loss of the pre-March 1, 1913, profits before there could be any accumulation of earnings or profits after February 28, 1913,

for distribution as a taxable dividend. The Court answered the question in the negative, pointing out that the fact that pre-March 1, 1913, profits were lost through operations supplied no basis for permitting profits accumulated after that date to escape, and in stating its conclusion therein, the Court took pains to point out that it was not there "concerned with capital in the sense of fixed or paid-in capital, which is not to be impaired, or with the restoration of such capital where there has been impairment."

The respondent makes one further argument, which is, that since the enactment of the Revenue Act of 1936, taxable dividends include distributions out of earnings or profits of the current year, computed as of the close of the taxable year, irrespective of a deficit existing at the time the distribution was made, and contends that since section 115 (a) of the Code makes no distinction between earnings or profits accumulated after February 28, 1913, and earnings or profits of the current year, as to taxability of distributions therefrom, there is no valid basis for adopting a statutory interpretation that would require restoration of an impairment of capital existing on March 1, 1913, out of earnings or profits realized on or after that date. The provision referred to first appeared in the Revenue Bill of 1936, as reported to the Senate by the Senate Finance Committee, and was enacted into law in the language which appeared in the bill. Respecting this provision, the Senate Finance Committee Report, Report No. 2156, 74th Congress, 2nd Session, page 18, contains the following:

Section 115 (a). Dividends Out of Current Earnings

In order to enable corporations without regard to deficits existing at the beginning of the taxable year to obtain the benefit of the dividends-paid credit for the purposes of the undistributed-profits surtax, section 115 (a) changes the definition of a dividend so as to include distributions out of the earnings or profits of the current taxable year. The amendment simplifies the determination by providing that distributions during the year, not exceeding in amount the current earnings, are dividends constituting taxable income to the shareholder and a dividends-paid credit to the corporation. As respects such dividends the complicated determination of accumulated earnings or profits is rendered unnecessary.

The language of the committee report indicates that as respects "earnings or profits accumulated after February 28, 1913" (emphasis ours), no change was intended in the law as it had been in prior acts, and that as to such distributions "regard to deficits existing at the beginning of the taxable year" and the "complicated determination of accumulated earnings or profits" would still be required. Only distributions from, and up to the amount of, the current earnings of the taxable year were intended to be freed of such requirements. The report, in recognizing the requirement for regard to deficits in the determination of earnings or profits accumulated after February 28, 1913, makes no distinction between deficits which arose prior to March 1, 1913, and those which arose after-

wards. A further answer to the contention of the respondent is that we are not here concerned with distributions made by an impaired capital corporation out of current earnings for the taxable years.

From the above, we think it follows that there can be no accumulation of profits until impaired capital has been restored. There is a difference, we think, between the realization currently of earnings and profits and the accumulation thereof. In other words, there can be no accumulation of earnings where profits, as earned, are absorbed in restoration of capital which has been impaired through previous operating losses, and it seems to us fundamental that it matters not whether the impairment occurred before or after March 1, 1913. It is accordingly our conclusion that the petitioners must be sustained in their contention that, in computing the accumulated profits of Oceanic and Kilauea after February 28, 1913, allowance must be made for the impairment of capital of those two corporations as of March 1, 1913.

In view of the conclusion above, it now becomes necessary to determine the issue stated by the parties as Issue 1, which is whether the transfer by Oceanic on November 16, 1912, of 23,647 shares of its capital stock to J. D. Spreckels & Bros. Company, in consideration for the cancellation of notes of Oceanic, reduced the amount by which Oceanic's capital had been impaired by operating losses.

Oceanic was incorporated under the laws of California, on December 24, 1881, with an authorized capital of 25,000 shares of common stock of \$100

par value per share. Payment of the subscription price of \$100 per share for the original 25,000 shares of stock issued was made upon calls by the corporation over a period of twenty years. These calls were described in the books of account as "assessments." By the end of 1902, the original issue of stock was fully paid, \$2,500,000 in cash having been received therefor. On April 29, 1903, an additional 25,000 shares of stock, of the par value of \$100 per share, was authorized, and was issued on April 30, 1903, to stockholders of record, pro rata. Upon the issuance of this stock, the capital stock account was credited with \$2,500,000 and an account entitled "Stock Bonus Account" was debited in like amount, and at all times thereafter the capital stock account remained on Oceanic's books at \$5,000,000. "At the date of this transaction the corporation had a deficit in excess of \$1,500,000, of which approximately \$750,000 resulted from operations of the business." Assessments were thereafter levied by the corporation on all shares of outstanding stock alike, whether of the original or second issue. After assessments were levied, like amounts were credited to the Stock Bonus Account. Altogether there were six such assessments, the first at \$2 per share and the others at \$10 per share. In each of the first four levies some shares failed to pay the assessments thereon. All shares on which assessments were not paid, were "bid" in by the corporation for the amount of the unpaid assessments, and in the case of the next assessment made, the assessments were made only on the shares left outstanding. The last of the six

assessments was made on October 3, 1907. As a result of the assessments, a total of \$1,393,654 was paid in, which, with the \$2,500,000 paid in for the original 25,000 shares, made \$3,893,654 as the total capital paid in to Oceanic for or on its stock. The number of shares left outstanding was 26,353, whereas 23,647 had been "bid" in by Oceanic for failure to pay assessments totaling \$132,846. The 23,647 shares were not cancelled, but were reissued in the name of Oceanic and were thereafter carried on its books as treasury stock, in the amount of \$134,210.26, being the unpaid assessments of \$132,846, plus \$1,364.26 representing "charges in connection therewith." The exact nature of the charges is not shown.

Over the years, J. D. Spreckels & Bros. Company advanced moneys for financing the activities of Oceanic. At November 16, 1912, that company held the notes of Oceanic in the amount of \$1,204,070.48, covering the advances and accrued interest. There was also accrued on that date interest on the notes in the amount of \$79,623.91. According to the books of J. D. Spreckels & Bros. Company, \$1,113,732.50 represented the amount of advances, whereas the balance of the face amount of the notes represented accrued interest on the advances. On November 16, 1912, Oceanic issued or transferred the 23,647 shares of its stock then carried on its books as treasury stock to J. D. Spreckels & Bros. Company, in consideration for the cancellation and surrender to it by J. D. Spreckels & Bros. Company of the notes of Oceanic in the principal amount of \$1,204,070.48,

together with accrued interest in the amount of \$79,623.91. On the same date a certificate for the said shares was issued to J. D. Spreckels & Bros. Company.

As a result of the above transaction, Oceanic made the following entries on its books of account: "On November 16, 1912, it charged 'Bills Payable' with the principal sum of said notes in the amount of \$1,204,070.48 and charged 'Interest Accrued on Notes' with the accrued interest thereon in the amount of \$79,623.91, the total of these two items in the amount of \$1,283,694.39 being credited to an account entitled 'Deficiency'; and the Treasury Stock account was credited with the balance remaining in said account in the amount of \$134,210.26 and this amount was charged to said 'Deficiency' account. On December 31, 1912, the balance of \$973,500.00 remaining in the stock bonus account was written off and this amount was charged to said 'Deficiency' account."

From its incorporation in 1892, to September 26, 1912, the stock of J. D. Spreckels & Bros. Company was entirely owned by J. D. and A. B. Spreckels, in equal amounts. On September 26, 1912, the said stock was transferred by the brothers, along with other property, to J. D. and A. B. Spreckels Securities Company in exchange for all of its capital stock. J. D. and A. B. Spreckels Securities Company was the predecessor of Spreckels Company. The parties have stipulated that the capital stock of Oceanic was worthless as of September 26, 1912.

The acquisition and disposition of the 23,647 shares of capital stock were the only transactions Oceanic ever had in its capital stock, other than the original issuance thereof.

On the facts, it is the contention of the respondent that Oceanic realized a gain of \$1,149,484.13, or otherwise reduced its operating deficit by that amount, upon the transfer of the 23,647 shares of its capital stock to Spreckels Company. The respondent arrives at the said amount as follows:

Principal amount of notes cancelled. . .	\$1,204,070.48
Accrued interest thereon.	79,623.91
	<hr/>
	1,283,694.39
Less bid in price on delinquent stock sales.	134,210.26
	<hr/>
	\$1,149,484.13

The petitioners contend that the said transaction was a capital transaction, which did not result in any realization of gain or otherwise reduce the operating deficit of Oceanic.

The facts as to Oceanic disclose rather unorthodox capital financing. The original issue of 25,000 shares of \$100 par value stock was subscribed for and in due course paid for in cash. Thereafter, and at a time when its capital was impaired, 25,000 additional shares of stock were authorized and issued to stockholders pro rata and book entries were made to show corporate capital at \$5,000,000, even though

no part of the additional \$2,500,000, to offset the increase in the capital stock account, was paid in. Instead a "Stock Bonus Account" of \$2,500,000 was set up, which, in the absence of other facts, might tend to indicate that the stockholders had subscribed for the added 25,000 shares of stock pro rata, at par, and that payment of the subscriptions would be made on calls by the corporation over a period of time, as was done in the case of the original 25,000 shares. The facts show, however, that such was not the case, but that thereafter assessments were levied, not on the new issue of 25,000 shares of stock, but on all shares equally, whether of the fully-paid original shares or the new shares. Six levies were made in all, and in each of the first four levies some shares failed to meet the assessments and the shares were taken over, "bid" in or forfeited, until at the conclusion of the six levies there were actually outstanding only 26,353 shares of stock and there had been paid in for the original 25,000 shares and on assessments a total of \$3,893,654. The fact that the corporation saw fit to place the "bid" in shares on its books as treasury stock, at the amount of the unpaid assessments, plus a small amount of unexplained costs, for which the shares were forfeited or "bid" in, and further saw fit to continue these shares at par in its capital stock liability account, in no way changes the actual factual picture. Regardless of bookkeeping entries indulged in, the facts were that there had been paid in on capital stock a total of \$3,983,654 and there

were outstanding only 26,353 shares of stock of a total par value of \$2,635,300. In other words, the net result of the issue of the additional shares of stock, the levies and collection of the assessments and the forfeiture or "bidding" in of the shares on which the assessments were not paid, was that additional payments on stock totaling \$1,393,654 were received, with a net increase in shares of stock actually outstanding of only 1,353 shares, having a total par value of only \$135,300. It thus appears that to the extent of the amounts which had been paid in on the forfeited shares Oceanic had received substantial amounts as paid-in capital, but as to the forfeited shares, it no longer had any capital stock liability, the over-all result being that the financial condition of both Oceanic and the holders of the 26,353 shares of outstanding capital stock had been substantially improved. In that situation, it might, with some force, be contended that the payments which had been made on the forfeited or "bid" in shares were, by such acquisition of shares, converted from capital to profits, thereby effecting a restoration of impaired capital or resulting in surplus profits available for distribution as dividends. The respondent, however, has advanced no such theory, and furthermore, under the general law of corporations, amounts which have been paid on forfeited shares may not be regarded as surplus profits, subject to distribution as dividends, or applied in restoring impaired capital, though when related to the reduction in capital stock still outstand-

ing there may have seemed to have been a realization of profits by the corporation.³ A statement of the general rule is found in section 5345, Volume 11, Fletcher's *Cyclopedia of the Law of Private Corporations*, which reads, in part, as follows:

§5345.—Property or money representing capital stock.

Property or money which represents an investment of the capital stock of a corporation, or of any part thereof, cannot be regarded as surplus profits, and distributed as dividends, irrespective of the financial condition of the corporation. When a person subscribes for or purchases shares of stock in a corporation, and pays a part only of the amount due thereon, and the shares are afterwards forfeited for non-payment of the balance, the amount paid is not profits, but a part of the capital, and cannot be divided among the stockholders. And the same is true of the proceeds of the sale by the corporation of shares of its own stock not previously issued, and of money paid into the treasury of the corporation by certain of its stockholders for the purpose of strengthening

³For cases where the question was whether a corporation realized taxable income upon forfeiture of shares for failure to pay the full amount of the subscriptions therefor, see *Realty Bond Mortgage Co. v. United States* (Ct. of Clms.), 16 Fed. Supp. 771; *Commissioner v. Inland Finance Co.*, 63 Fed. (2d) 886, affirming 23 B. T. A. 199; and *Illinois Rural Credit Association*, 3 B. T. A. 1178.

the company and adding to its working capital, and for which no additional stock is issued.

* * *

The stockholders of a corporation have the right to a division of its capital among them, after payment of its debts, when the corporation has been dissolved.

Nor is the rule questioned that a surplus arising from a lawful reduction of the capital stock is available for dividend purposes and may be lawfully distributed as such. The fund thus distributed is sometimes called a 'dividend,' but it is very different from a dividend out of profits.

Whether or not the parties have based their alternate computations of the "operating deficit" of Oceanic on paid-in capital of \$3,893,654 as of the date of issuance of the 23,647 shares to J. D. Spreckels & Bros. Company, on November 16, 1912, is not at once apparent. Inasmuch, however, as the issue as to the amount of the "operating deficit" at March 1, 1913, has been submitted by stipulation of the parties on the narrow proposition whether the issuance of the 23,647 shares in consideration of the cancellation of Oceanic's notes and the accrued interest thereon resulted in gain to Oceanic or otherwise reduced its "operating deficit," we have no occasion to look behind the stipulated results, however computed.

The 23,647 shares of stock were carried on the books of Oceanic as treasury stock. Treasury

shares are presently defined in section 278 of the Civil Code of California as "shares issued and thereafter acquired by the corporation, but not retired or restored to the status of unissued shares." And while the authorities are not in complete agreement as to the procedure or method whereby a corporation may properly acquire and thereafter hold its shares as treasury stock, they do seem to agree that the holding of such shares is for use or disposition by the corporation "in furtherance of corporate purposes," or, differently stated, is for the purpose of subsequent sale to procure working capital. See section 5099, Volume 11, Fletcher's Cyclopedia of the Law of Private Corporations; *Borg v. International Silver Co.*, 11 Fed. (2d) 147; *Shores v. Dakota-Montana Oil Co. (N. D.)*, 237 N. W. 172; *Maynard v. Doe Run Lead Co. (Mo.)*, 265 S. W. 94; *State ex rel, Moore v. Manhattan Verde Co. (Nev.)*, 109 Pac. 442. An apt analysis of the character and substance of treasury shares is given by Justice Learned Hand, in his opinion in *Borg v. International Silver Co.*, *supra*, wherein he said, "To carry the shares as a liability, and as an asset at cost, is certainly a fiction, however admirable. They are not a liability, and on dissolution could not be so treated, because the obligor and obligee are one. They are not a present asset, because, as they stand, the defendant [the corporation] cannot collect upon them. What in fact they are is an opportunity to acquire new assets for the corporate treasury by creating new obligations. In order to indicate this potentiality, it may be the best accounting to carry

them as an asset at cost, providing, of course, all other assets are so carried. * * * In any event there can be no ambiguity in stating the facts more directly * * *; that is, in treating the shares as not in existence while held in the treasury, except as a possible source of assets at some future time, when by sale at once they become liabilities and their proceeds assets. It makes no difference whether this satisfies ideal account or not."

That the issuance of the 23,647 shares to J. D. Spreckels & Bros. Company on November 16, 1912, was in character a capital-producing transaction and in no way resulted in the realization of gain or a restoration of Oceanic's impaired capital, is not, in our opinion, open to doubt. Looking to realities, the acquisition of these shares was not the purchase by Oceanic of an asset. While they are described as having been "bid" in for the amount of the unpaid assessments against them, and Oceanic carried them at a book cost equal to the amount of such unpaid assessments, plus a small amount of unexplained expenses, the effect of their acquisition was that of forfeiture for failure to pay the assessments or calls against them, made apparently in accordance with the terms of their original issue. In their reacquisition there was no outgo from either capital or profits, and the cost figures on Oceanic's books were accounting entries, nothing more. Certainly, on the facts here, these shares in the hands of Oceanic had no function or substance, and served no purpose, except for future sale or issue for the production of capital, with the attendant result that upon sale or

issue they would likewise become an added capital stock liability. In order for the transaction to result in a realization of gain or otherwise reduce Oceanic's "operating deficit," as the respondent contends, it seems to us inescapable that Oceanic must come out of the transaction with either an increase in assets over what it had before and without an attendant increase in liabilities, or the assets which it did have must have been freed or released, to some extent, of the liabilities which enter into the computation of capital and surplus. Plainly no such results ensued. To put the transaction in its best light, from the standpoint of the respondent, it, at the most, resulted in change of a notes payable and accrued interest liability into a capital stock liability of equal or greater amount. In determining whether there are net profits from which dividends must be declared, the capital stock liability must be taken into account, just as would a notes payable liability. Section 5335, Volume 11, Fletcher's *Cyclopedia of the Law of Private Corporations*, *supra*. Such being the case, the change here could not possibly have resulted in gain or in the restoration of impaired capital. In reaching this conclusion, we do not overlook the cases wherein it has been decided that a corporation may, and in some instances has, realized taxable gain upon the acquisition and resale of its own shares. See and compare *The M. Conley Co.*, 6 T. C. 250; *Rollins Burdick Hunter Co.*, 9 T. C. 169; *Cluett, Peabody & Co.*, 3 T. C. 169; *Dr. Pepper Bottling Company of Mississippi*, 1 T. C. 8. Neither do we decide that a

corporation may not traffic in its own shares in such manner that some part of the proceeds from a resale of such shares would properly go to profits, rather than to the enhancement of its capital fund. We do conclude, however, that such was not the result of the transaction here in question.

The last issue presents the question whether upon liquidation of Monterey County Water Company and Seventh and Hill Building Corporation, wholly-owned subsidiaries of Spreckels Company, deficits resulting in impairment of capital after February 28, 1913, were, under the rule in *Sansome v. Commissioner*, 60 Fed. (2d) 931, continued as a deficit to Spreckels Company which would have to be restored out of Spreckels Company profits in computing the earnings and profits of Spreckels Company after February 28, 1913. The Monterey County Water Company was dissolved on November 18, 1936, and on that date its capital was impaired by reason of operating losses after March 1, 1913, in the amount of \$47,030.64. Seventh and Hill Building Corporation was dissolved on December 13, 1938, and when dissolved, its capital was impaired by operating losses sustained after February 28, 1913, in the amount of \$98,594.01.

These liquidations were within the meaning of section 112 (b) (6) of the Revenue Acts of 1936 and 1938, respectively, which provides for the non-recognition of gain or loss upon such transactions.

On authority of *Commissioner v. Phipps*, 336 U. S. 410, reversing 167 Fed. (2d) 117, we hold that the

operating deficits of the above-mentioned subsidiaries transferred upon their liquidation to the parent company do not serve to reduce the latter's accumulated earnings or profits available for distribution as taxable dividends in the years involved herein. Effect thereto, and also effect to the appropriate schedules contained in the stipulation, will be given in the recomputation under Rule 50.

The extent to which the distributions made by Spreckels Company in 1938, 1939 and 1940 were paid out of its earnings or profits available for distribution as dividends, will be determined pursuant to this opinion and the appropriate schedules contained in the stipulations, under Rule 50.

Review by the Court.

Decisions will be entered under Rule 50.

Tyson, J. concurring:

I agree with the result reached in the majority opinion on the first and third issues. I also agree with the result reached on the second issue that Oceanic's acquisition and subsequent disposition of shares of its own capital stock were a capital transaction which did not result in the realization of profits or otherwise reduce the then existing impairment of capital of Oceanic. However, I do not agree that the record establishes the existence of the basic fact upon which the opinion's rationale on this issue is predicated; that fact being that the shares of stock against which the assessments had been levied were acquired by Oceanic by forfeiture. That the rationale of the opinion is based on such a basic fact

is clearly shown by a statement in the opinion made, after citation of authorities as to the effect of forfeiture of stock and some subsidiary questions. That statement is as follows:

* * * Looking to realities, the acquisition of these shares was not the purchase by Oceanic of an asset. While they are described as having been "bid" in for the amount of the unpaid assessments against them, and Oceanic carried them at a book cost equal to the amount of such unpaid assessments, plus a small amount of unexplained expenses, the effect of their acquisition was that of forfeiture [Emphasis supplied] for failure to pay the assessments or calls against them, made apparently in accordance with the terms of their original issue. In their reacquisition there was no outgo from either capital or profits, and the cost figures on Oceanic's books were accounting entries, nothing more. * * *

If it were shown as a fact that the shares in question were acquired by Oceanic by forfeiture, as the majority opinion finds they were, I would not disagree with the rationale of that opinion on the second issue. However, not only is the fact that Oceanic acquired the shares by forfeiture not shown by the record, but also they are affirmatively shown to have been acquired by purchase and not by forfeiture, since the written stipulation of the parties on this point is as follows:

The shares of stock on which the assessments listed in the preceding schedule had not been paid were bid in by the corporation pursuant to delinquency sale [Emphasis supplied] and thereafter carried on its books as treasury stock in the amount of \$134,210.26. Said \$134,210.26 represented the total of the unpaid assessments for which these shares were bid in together with charges in connection therewith. * * *

From the above quoted stipulation it clearly appears that the assessed shares were acquired by Oceanic by purchase for a consideration, and this being so, I think that proper consideration of this issue can be had only on the established facts: (1) That there was a purchase of the assessed shares by Oceanic, and (2), of course, that there was a resale of them thereafter by Oceanic. When so considered I think disposition of the issue should be in favor of the petitioners under authority of a long line of cases holding that, as a general rule of law, when a purchase and subsequent resale of its own stock are made by a corporation no gain or loss to the corporation is realized thereby. *Simons & Hammond Manufacturing Co.*, 1 B. T. A. 803, a leading case; *Cooperative Furniture Co.*, 2 B. T. A. 165; *Atlantic Carton Corporation*, 2 B. T. A. 380; *Hutchins Lumber & Storage Co.*, 4 B. T. A. 705; *Farmers Deposit National Bank*, 5 B. T. A. 520; *H. S. Crocker Co.*, 5 B. T. A. 537; *Interurban Construction Co.*, 5 B. T. A. 529; *Liberty Agency Co.*, 5 B. T. A. 778; *Union Trust Co. of New Jersey*, 12 B. T. A. 688; and *105 West 55th Street, Inc.*, 15 B. T. A. 210.

There is no question that the transaction here in-

volved is not one where "a corporation deals in its own shares as it might in the shares of another corporation" even if the principle set out in these words in the amendment of May 2, 1934, to the regulations applied to the transactions here involved which took place many years before the date of the amendment, for the reasons that: Oceanic purchased its own shares at a delinquency sale necessitated by failure of some of its stockholders to pay assessments levied on their stock; Oceanic held the purchased shares comprising almost one-half of its total authorized and issued stock as treasury stock for a period of six or seven years before its resale; when the resale was made Oceanic was insolvent and its shares were worthless; and no other purchases or sales of its own shares were ever made by Oceanic, except in the sale of its original issues.

Briefly stated, the error in the majority opinion on this issue is, I think, that it has applied a principle of law premised upon a basic fact, i.e., that Oceanic acquired the assessed stock by forfeiture—which fact is affirmatively shown not to have existed—whereas, I think a different principle of law should be applied and premised upon the real facts affirmatively shown to have existed, i.e., that Oceanic acquired the stock by purchase at the delinquency sale and thereafter sold the stock thereby bringing the transactions within the general rule of law established by the above cited authorities, that a corporation realizes no gain from a purchase and resale of its own stock.

Leech, J., agrees with this concurring opinion.

Disney, J., dissenting:

I can not agree with the majority that in determining earnings or profits accumulated after February 28, 1913, pre-March 1, 1913, operating deficits impairing capital must be restored out of subsequent earnings or profits.

We are here concerned not with a corporation or its accounting methods, but with the taxation of a stockholder who has received distribution of corporate earnings which were actually earned since February 28, 1913. In my opinion, such stockholder is taxable thereon, under clear legislative mandate.

The majority opinion cites various cases which in nowise involve or decide the present question: *Foley Securities Corporation*, 38 B. T. A. 1036; *aff'd.*, 106 Fed. (2d) 731, involved dividends paid credit of a personal holding company, and distinguishes the present situations by holding that there is no accumulation of earnings or profits until an operating loss is made good "*if incurred after March 1, 1913.*" (Italics supplied.) The corporation therein was organized in 1928, so our question could not there occur. The same is true of *Arthur C. Stifel*, 29 B. T. A. 1145, and *Commissioner v. W. S. Farish & Co.*, 104 Fed. (2d) 833. In *Roy J. Kinnear*, 36 B. T. A. 153, there was on March 1, 1913, a paid-in surplus of about \$2,500,000, and the question was the effect of later operating losses. *Loren D. Sale*, 35 B. T. A. 938, involved a stipulation of operating loss for the period after March 1, 1913, computed on March 1, 1913, values, and it was held that such

stipulation does not show that capital or paid-in surplus was ever impaired. So the present question as to restoration of lost capital out of subsequent earnings was not at issue. In *Crystal Ice Co.*, 14 B. T. A. 682, relied on by the *Sale* case, *supra*, though the corporation was organized in 1912, there was from organization up to December 31, 1914, an earned surplus of about \$23,000 and the deficits involved were incurred later. In *J. L. Washburn*, 16 B. T. A. 1091, also cited in the *Sale* case, it appears that the deficit involved was incurred in 1923. Obviously such cases do not reach our difficulty here, and I find no help in them. *Hadden v. Commissioner*, 49 Fed. (2d) 709, also so cited, is indeed to the contrary, for examination thereof reveals that the corporation had, as in this case, an operating deficit, up to March 1, 1913, of about \$500,000, and from that date to April 30, 1917, an operating loss of \$329,549.22. Yet in computing corporate earnings and profits on the question of taxability of dividends the Court subtracted, from later earnings, only the \$329,549.22 and not the \$500,000. That this was intended is shown in the following language:

* * * Operating losses sustained *after March 1, 1913*, must be deducted from profits realized after that date before they can be a taxable profit * * * . (Italics supplied.)

The Court says this, and, as above seen, does not deduct pre-March 1, 1913, operating loss, though in the previous sentence it had broadly said:

* * * Dividends paid while there is an operating deficit should be deemed to be from capital or paid-in surplus * * * .

This generality, shown so to be by the Court's next language, above quoted, and its action, appears to be the ratio decidendi of the majority here, i.e., that as a general proposition dividends paid in the face of an operating deficit should be regarded as from capital, or paid-in surplus. With this broad concept I do not disagree. But we here have a question of the effect for income tax purposes of the date March 1, 1913, and what Congress intended. Neither the general concept, nor cases involving only post-March 1, 1913, deficits afford us light. Indeed such cases, above distinguished, seem inherently based upon the idea that, within the intendment of "earnings or profits accumulated after February 28, 1913," there was no accumulation, because no net accumulation, due to deficits within that period. This is shown in the references to the definition of dividend in section 115 in such cases as *Foley Securities Corporation*, *Roy J. Kinnear*, and *Loren D. Sale*, *supra*.

Since the money here involved as distributed to stockholders was in fact earned by the corporation since February 28, 1913, it is to be presumed that Congress, intending to use its taxing power to the fullest extent, intended to tax such funds. *Irwin v. Gavit*, 268 U. S. 161; *Helvering v. Stockholms Enskilda Bank*, 293 U. S. 84. In *Frank D. Darrow*, 8 B. T. A. 276, we said:

Though Congress exempted from taxation as dividends or otherwise, distributions of earnings accumulated prior to March 1, 1913, at the same time it so defined taxable dividends as to include every distribution of earnings accumulated since February 28, 1913, in whatever form the distribution might be made. The intention of Congress to tax as dividends, distributions, however made, of earnings since February 28, 1913, is evident from the broad and comprehensive language of the definition and the specific inclusion of stock dividends to the extent of such earnings. * * *

Eisner v. Macomber, 252 U. S. 189, held stock dividends non-taxable. After March 1, 1913, "dividends declared and paid * * * whether out of current earnings or profits accumulated prior to that date [not here involved] constituted income to the stockholders and not capital and were taxable as income if the Congress saw fit to impose the tax." *Helvering v. Canfield*, 291 U. S. 163. Did Congress so intend? The petitioner here is seeking immunity from tax, that is, is seeking an exemption, a matter of legislative grace. She has, therefore, the burden of showing a clear and unambiguous statutory right to such exemption from tax. *Wright v. Georgia R. R. & Banking Co.*, 216 U. S. 420; *New Colonial Ice Co. v. Helvering*, 292 U. S. 435; *White v. United States*, 305 U. S. 281. Exemptions can not rest on implication, doubt, or ambiguity; *United States v. Stewart*, 311 U. S. 60; or inference, *Pacific Co., Ltd. v. Johnson*, 285 U. S. 480.

The majority view here is seen as resting on nothing else. The most that appears to be relied on is possible ambiguity in the word "accumulation," in Section 115 of the Internal Revenue Code. Section 115, defining dividends, not only fails to provide for exemption from taxation of dividends to the extent there were pre-March 1, 1913, operating or capital deficits, but affirmatively defines dividend as being, inter alia, a distribution out of "earnings or profits accumulated after February 28, 1913"; and, what is even more significant, in providing exemption from tax, as to the period before March 1, 1913, carefully limited itself to providing that "any earnings or profits accumulated, or increase in value of property accrued before March 1, 1913, may be distributed exempt from tax * * *." "*Inclusio unius est exclusio alterius*" never applied more clearly. The exemption desired by the petitioner is excluded. The statute, instead of showing the clear right to exemption which petitioner must show, to the contrary clearly negatives such right. It is to be noted also, in the language last quoted, the recognition of "earnings or profits accumulated * * * before March 1, 1913,"—a plainly intended contrast to "earnings or profits accumulated after February 28, 1913," in the preceding subsection, 115(a). Yet the majority view, insofar as it is able to rely on section 115 at all, is that (because of general ideas of corporate profit existing only after repairment of capital and because the cited cases above-mentioned hold that post-February 28, 1913, operating losses may be re-

couped out of earnings and profits before accumulation of profits to pay taxable dividends) "there can be no accumulation of post-February 28, 1913, profits for the purpose of distributing taxable dividends, until impaired capital at March 1, 1913, has been restored." But this only amounts to the argument that on this tax question, before taxable dividends can be paid, there must be net profits from the inception of the corporation, and that though Congress defined a dividend as from accumulations after February 28, 1913, and used "accumulated" to refer to two distinct periods, before and after that date, yet the word must be held to refer to and encompass the whole corporate life so that, for present tax purposes, there is no accumulation of earnings and profits because of capital impairment in the earlier period. But the statute does not say "profit" or "net profit" or "net profit [or net accumulations] over corporate life," but only "earnings or profits accumulated after February 28, 1913." The text of the *Canfield* case indicates that the petitioner there made the same argument as here, for the Court says: "The argument for the stockholders stresses the word 'accumulated.' We think that the expression is made to carry too heavy a burden."

In my opinion, the language of section 115 obviously and affirmatively refutes the majority view. It subjects all of the net accumulations of earnings or profits after February 28, 1913, to taxable distribution. Under the *Canfield* case, where deficits apply against March 1, 1913, surplus, later lost, and not against later earnings, we see even more

than the post-March 1, 1913, net so subjected to tax. It does not carve out or except any amount equivalent to operating deficits or capital losses prior to that date. The only provision of that nature, or as to the earlier period, is as to tax-free distribution of earnings or profits as to the time before February 28, 1913. In addition to the above reasons for so believing, I note that section 115(b) also states that "for the purposes of this chapter every distribution is made * * * from the most recently accumulated earnings or profits"; further that earnings or profits accumulated before March 1, 1913, may be distributed only after distribution of those accumulated after that date. It is clear that Congress had a concept of "accumulation" as being in three chronological categories, completely contrary to the majority's idea of considering the corporate life, even prior to March 1, 1913, as one continuous period of accumulation. It seems to me impossible to read section 115(a) and to conclude that "accumulated after February 28, 1913," means accumulated both before and after that time, when the word is used as to three distinct periods. Accumulation may be recent, may be back to February 28, 1913, and may be before that date. And so far as the phrase "earnings or profits" is concerned a corporation has profits, taxable profit, despite earlier deficits. *Long Beach Improvement Co.*, 5 B. T. A. 590. There it was held that although net income of a corporation for 1920 was insufficient to wipe out a pre-existing deficit ("for several years prior to 1919") nevertheless such income was taxable to the corporation.

This can only mean that the corporation actually had "earnings or profits" for 1920 despite its previous deficit. How then can it be said that such corporation did not have "earnings or profits" within the definition of dividend in section 115? In the Long Beach case the Court disagreed with the petitioner's contention that net income was something different when applied to a corporation from "gain, net gain, profit, net profit." Thus we see that that corporation had net profit for 1920 despite earlier capital deficits. It would in that respect be immaterial whether those deficits were before or after March 1, 1913. In *Cranson v. United States*, 146 Fed. (2d) 871, *Long Beach Improvement Co.*, *supra*, was cited and approved. It is relied on for the above conclusion in *Foley Securities Corp.*, *supra*, (one of the cases relied on by the majority here), where we said:

* * * There is no doubt that the term "income" as used in the Sixteenth Amendment is broad enough to cover current corporate income even though a deficit may exist. Congress can and does impose a tax on such income. * * *

In my view, not only is there within section 115 accumulation, but accumulation of "earnings or profits" after February 28, 1913, though there is capital impairment prior to that date.

In *Helvering v. Canfield*, *supra*, the Court had, as it said, no case of impairment of capital but it also said "We are dealing with a distribution of accumu-

lated profits." They referred to profits accumulated from 1917 to 1923. The Court continued:

* * * When a corporation continued in business after March 1, 1913, the dividends it later declared and paid to its stockholders, whether out of current earnings or from profits accumulated prior to that date, constituted income to the stockholders, and not capital, and were taxable as income if the Congress saw fit to impose the tax. *Lynch v. Hornby*, 247 U. S. 339, 38 S. Ct. 543, 62 L. Ed. 1149. * * *

I suggest that Congress has clearly, in section 115, seen fit to impose the tax, and that the majority has not demonstrated otherwise.

In the *Canfield* case the Court had the question whether earnings or profits actually earned in 1917-1923 should be distributed tax free, because of a theory that they should go to replace earlier losses of surplus which had existed on March 1, 1913. The Court held that the surplus, embarked in the business after March 1, 1913, had actually been lost and referring to the contention that later distributions should replace the loss, as: "immunity is sought from the taxation of an equivalent amount of profit subsequently earned," denied the immunity. The following language from the Court is highly pertinent here:

Paragraphs (a) and (b) of section 201 disclose a single purpose, and are to be construed in harmony with each other. They show that the

Congress was careful to arrange its plan so that the right to receive, free of tax, a distribution of surplus accumulated prior to March 1, 1913, should not be exercised in such a fashion as to permit profits accumulated after that date to escape taxation. To that end the Congress provided that "every distribution is made out of earnings or profits, and from the most recently accumulated earnings or profits, to the extent of such earnings or profits accumulated since February 28, 1913." Then follows *the exemption which is strictly limited to a distribution of profits accumulated prior to March 1, 1913*. Nothing is said as to a restoration of those profits out of subsequent earnings if the former have been lost. (Italics supplied.)

I emphasize that the Court not only refers to the matter as an exemption, but also that it says that it is strictly limited to distribution of pre-March 1, 1913, profits. Nothing is said in section 115(a) as to restoration of lost profits or about subsequent earnings, or as to restoration of lost pre-March 1, 1913, capital therefrom. Again the Court: "But the actual course of events is not to be ignored." It seems clear that the case stands for the proposition that corporation profits actually accumulated after March 1, 1913, were by Congress subjected to tax. Just as the right to receive, free of tax, surplus accumulated before March 1, 1913," should not be exercised in such fashion as to permit profits accumulated after that date to escape taxation" so, in my view, the

general concept of capital repairment should not be so strained (here as to a period prior to February 28, 1913), as to overthrow the text and intendment of section 115, and cause exemption from tax. Exemption from tax "strictly limited" can not encompass such an end. I can not conceive why, if loss of surplus accumulated on March 1, 1913, is not in the Canfield case permitted to work such an effect, a still earlier loss of capital, prior to March 1, 1913, should be accorded a different result, and profits admittedly earned since the inception of income tax be freed from tax.

In *Hoffman v. United States*, 53 Fed. (2d) 282, the corporation had a pre-March 1, 1913, operating loss of about \$211,000, and a profit of \$132,000 from March 1, 1913, to December 31, 1913. In the course of the opinion the Court says:

* * * If the profit of 1913 had been distributed in that year, we think it would have been taxable, notwithstanding there was an operating deficit prior to March 1 of that year. * * *

The corporation's assets had increased in value, prior to March 1, 1913, and the opinion holds that such increase was distributable free of tax in 1917, but nowhere do I find the taxable amount, of a dividend paid in 1917, affected by the \$211,000 pre-March 1, 1913, operating loss, though other distributions and profits and losses after 1913 had to be considered in fixing the amount.

The majority finds *Chapman v. Anderson*, 11 F.

Supp. 913, in point. The petitioner on brief called this "the only case in which this case has been squarely decided." Yet there the Court was concerned only with whether an entry on corporate books writing up assets by \$274,838.97, to reflect value on March 1, 1913, was earnings or profits applicable to reduce an operating deficit of that date so as to affect taxability of distribution on stock in 1925-1926—and the Court held it was not. The present question seems not to have been presented. "The only point at issue is the interpretation to be given to the write-up of the sum of \$274,838.97." The Court did no more than assume, without analysis of the problem, that pre-March 1, 1913, operating deficits must be restored, the same as post-March 1, 1913, deficits.

In *Frank D. Darrow, supra*, we held that because there was in the Revenue Act of 1921 no provision excluding liquidating distributions from earnings or profits since February 28, 1913, from general statutory definition of dividend, they were above capital to be taxed as dividends. We said:

Again we find clearly expressed the intention of Congress to tax as a dividend every distribution of earnings accumulated since February 28, 1913, in whatever form or manner made, and in the absence of a contrary intent appearing from the Act, a liquidating distribution of such earnings would be taxable as other dividends. * * *

The Darrow case is cited and approved in *McCaughn v. McCahan*, 39 Fed. (2d) 3, and various other cases to the same effect.

Thus it is seen that a definite statutory provision (such as has been in the revenue acts since 1924, as to liquidating distributions) is necessary to exclude any dividend from the broad sweep of Congressional intent and the language found in section 115(a). The majority points to no statute, except to the extent that it interprets "accumulated" in section 115(a), but relies on general ideas not related to the revenue acts since 1913.

Again, I note that the regulations, e.g., Regulations 94, Section 115, have long set forth the requirements of a dividend, and among other statements we find that a distribution of earnings or profits accumulated prior to March 1, 1913, is not a dividend; also that in determining source of a distribution, earnings or profits accumulated prior to March 1, 1913, are to be considered only "after all the earnings or profits of the taxable year and all the earnings or profits accumulated since February 28, 1913, have been distributed." Again: "A loss sustained for a year prior to the taxable year does not affect the earnings or profits of the taxable year" (with discussion of exceptions not here pertinent. No exception is made as to pre-March 1, 1913, capital impairment). These provisions of the regulations seem to me to show that dividends are there construed as not to require consideration of capital losses in the pre-March 1, 1913, period. The idea ap-

proved by the majority is not set forth in the regulations, just as it is found lacking in the statute. The repeated reenactment of the statute so construed by the regulations, gives to them the effect of law, and precludes the interpretation given by the majority. *Helvering v. R. J. Reynolds Tobacco Co.*, 306 U. S. 110. Congress, in my view, did not contemplate immunity from taxability of earnings after March 1, 1913, by deduction of capital invested, but already lost by that date. The capital as it stood at that date appears to me properly the source of later income. Income is "fruit born of capital." *United States v. Safety Car Heating & Lighting Co.*, 297 U. S. 88. The part earlier lost was not risked in the business after February 28, 1913, as was the March 1, 1913, surplus in the Canfield case.

Under section 113(a) (14) the stockholder may take either cost or March 1, 1913, fair market value, whichever is greater, as his basis, for determining gain, and the section provides that in determining such value due regard shall be given to value of the corporate assets. The stockholder can be taxed with gain, only above his pre-March 1, 1913, cost, and not above value on that date, if less than cost. *Goodrich v. Edwards*, 255 U. S. 527. He is, therefore, both by the statute and the constitutional principle as laid down in the Goodrich case, protected against pre-March 1, 1913, depreciation in value in his stock, in the computation of profit or loss, upon sale. I, therefore, discern no reason for allowing him non-taxability, with the attendant adjustment downward

of his base, when he receives a dividend, sufficient to override the plain statutory definition of dividend as distribution of post-February 28, 1913, profits. He is, in effect, not affected, in the end, by the pre-February 28, 1913, operating deficit affecting value of his stock, since he may take cost, at an earlier date, as basis, and the majority view would merely accelerate recovery of a part of his basis, deferring tax until disposition of the stock. Ground therefor, contrary to the text of section 115, does not appear. March 1, 1913, has a definite meaning for income tax purposes, and general ideas of corporate accounting are subject thereto and to the language of section 115. I am not assisted, on this question, by *Willcutts v. Milton Dairy Co.*, 275 U. S. 215, as to invested capital and excess profits. It states specifically that *Long Beach Improvement Co.*, *supra*, "is not of moment. The deductions from gross income allowed by that Title [Title 2 of the Revenue Act of 1918, as to income tax] do not refer to invested capital, surplus or undivided profits, and its provisions throw no light upon the meaning of those terms as used in Title 3 providing for an excess-profits tax." *Lynch v. Hornby*, 247 U. S. 339, though based on the Act of 1913, and with no reference to the particular question here, is opposed to the majority view, though therein cited; for it stands for the principle that under the broad definition of income, Congress was at liberty to tax all dividends declared and paid in the ordinary course "after taking effect of the act (March 1, 1913)," even though derived

from pre-March 1, 1913, earnings, unless as later in the income tax Acts of 1916 and 1917, Congress saw fit specifically to except such pre-March 1, 1913, earnings from taxation. So here, without a statute of similar import, it is submitted that operating deficits prior to the effective date of the first income tax act have not been given tax-immunizing effect, in the face of the broad definition of dividend in section 115(a) and the Congressional intent to use its full taxing power. To point up my view, above expressed, that "accumulation" is separately applied to the post-February 28, 1913, period, *Lynch v. Hornby* itself does so; for, discussing undivided profits before declaration of a dividend, it is said:

This treatment of undivided profits applies only to profits permitted to accumulate after the taking effect of the act, since only with respect to these is a fraudulent purpose of evading the tax predicable. Corporate profits that accumulated before the act took effect stand on a different footing. * * * (Emphasis supplied.)

I would not diminish earnings or profits in fact accumulated since February 28, 1913, by capital deficits prior thereto, and, therefore, I respectfully dissent.

Arnold and Oppen, JJ., agree with this dissent.

Served Dec. 21, 1949.

The Tax Court of the United States
Washington

Docket No. 5333

GRACE H. KELHAM,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DECISION

Pursuant to the Court's Findings of Fact and Opinion, promulgated December 20, 1949, the respondent herein filed a computation of tax on February 28, 1950, and the petitioner on the same date filed an acquiescence in the respondent's computation. In accordance therewith it is

Ordered and Decided: That for the year 1940 there is an overpayment in income tax of \$59,424.62, which amount was paid after the mailing of the notice of deficiency.

Enter:

/s/ BOLON B. TURNER,
Judge.

Entered Mar. 14, 1950.

Served Mar. 15, 1950.

In the United States Court of Appeals
for the Ninth Circuit

T. C. Docket No. 5333

COMMISSIONER OF INTERNAL REVENUE,
Petitioner on Review,

vs.

GRACE H. KELHAM,

Respondent on Review.

PETITION FOR REVIEW

To the Honorable Judges of the United States Court
of Appeals for the Ninth Circuit:

The Comissioner of Internal Revenue hereby petitions the United States Court of Appeals for the Ninth Circuit to review the decision entered by The Tax Court of the United States on March 14, 1950, "That for the year 1940 there is an overpayment in income tax of \$59,424.62" in respect of the Federal income tax liability of Grace H. Kelham, the above-named respondent on review. This petition for review is filed pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code.

The respondent on review, Grace H. Kelham, is a resident of California whose mailing address is 1110 Crocker Building, San Francisco, California. Respondent's Federal income tax return for the calendar year 1940, the taxable year here involved, was filed with the Collector of Internal Revenue for the

First District of California, whose office is located in San Francisco, California, and within the jurisdiction of the United States Court of Appeals for the Ninth Circuit where this review is sought.

Nature of Controversy

During the taxable year 1940 the respondent on review was the owner of 6 shares of stock of J. D. and A. B. Spreckels Company and voting trust certificates representing 972 shares of the capital stock of said company, in respect of which shares she received during the year 1940 distributions in the amount of \$66,504.00. The respondent was also the beneficiary of a trust among the assets of which trust were voting trust certificates representing 1,340 shares of the capital stock of J. D. and A. B. Spreckels Company. As a part of her share of the distributable income of said trust for the year 1940, the respondent received from the trustees, as her net share of distributions made to the trust by the J. D. and A. B. Spreckels Company in 1940 on said 1,340 shares, the sum of \$45,560.00. In her Federal income tax return for the year 1940 the respondent returned as taxable income only \$11,922.64 in respect of the shares of J. D. and A. B. Spreckels Company owned directly by her and only \$10,327.56 in respect of her share of distributions made to the trust. In his redetermination of the respondent's tax liability for the year 1940 the Commissioner increased the distributions returned by the respondent to their full amounts.

It was the taxpayer's contention before The Tax Court of the United States, among other things, that in determining the percentages or amounts of the distributions made by the J. D. and A. B. Spreckels Company which represented taxable dividends in the hands of the recipients thereof it is necessary to first restore out of subsequent earnings and profits the pre-March 1, 1913, accumulated operating losses, or deficits, of the predecessor of J. D. and A. B. Spreckels Company and its affiliated companies. The Commissioner contended, on the other hand, that operating deficits as of March 1, 1913 may not be restored by subsequent earnings and profits in determining the amount of earnings or profits accumulated after February 28, 1913, which would constitute taxable dividends to the recipients in whole or in part. The Tax Court of the United States disagreed with the Commissioner's determination and allowed the restoration of pre-March 1, 1913, accumulated operating losses for the purpose of determining the amount of subsequent earnings and profits available for distribution as taxable dividends.

/s/ THERON L. CAUDLE,

Assistant Attorney General.

/s/ CHARLES OLIPHANT,

Chief Counsel Bureau of Internal Revenue, Attorneys for Petitioner on Review.

Received and filed June 2, 1950, T.C.U.S.

The Tax Court of the United States

Docket No. 5334

LEILA H. NEILL,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION

The above named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (San Francisco—IRA:90D-LB) dated May 26, 1944, and as a basis of her proceeding alleges as follows:

1. Petitioner is an individual, whose mailing address is 1110 Crocker Building, San Francisco, California. The return for the period here involved was filed with the Collector for the First District of California.

2. The notice of deficiency (a copy of which is attached hereto and marked "Exhibit A") was mailed to petitioner on May 26, 1944.

3. The taxes in controversy are income taxes for the calendar years 1938, 1939 and 1940, in the respective amounts of \$9,694.00, \$13,975.37 and \$46,595.38.

4. The determination of tax set forth in said notice of deficiency is based on the following errors:

(a) The Commissioner erred in disallowing as a deduction interest paid by petitioner during the calendar year 1938 in the amount of \$7,213.96.

(b) The Commissioner erred in disallowing as a deduction interest paid by petitioner during the calendar year 1940 in the amount of \$5,273.73.

(c) The Commissioner erred in determining that distributions made by J. D. and A. B. Spreckels Company to its stockholders during the calendar year 1938 were paid out of earnings or profits to the extent of 100% thereof, and the Commissioner erred in failing to find that no portion of said distributions were paid out of earnings or profits, and in failing to allow in full petitioner's claim for refund of income taxes paid for the year 1938.

(d) The Commissioner erred in determining that distributions made by J. D. and A. B. Spreckels Company to its stockholders during the calendar year 1939 were paid out of earnings or profits to the extent of 100% thereof, and the Commissioner erred in failing to find that at least 45.186% of said distributions were not paid out of earnings or profits, and in failing to allow to that extent petitioner's claim for refund of income taxes paid for the calendar year 1939.

(e) The Commissioner erred in determining that distributions made by J. D. and A. B. Spreckels Company to its stockholders during the calendar year 1940 were paid out of earnings or profits to the extent of 100% thereof, and as a result of said determination increasing petitioner's income for the year 1940 by the amount of \$91,892.48, and the

Commissioner erred in failing to find that at least 79.792% of said distributions were not paid out of earnings or profits.

(f) The Commissioner erred in disallowing as a deduction expenses paid by petitioner during the calendar year 1938 in the amount of \$222.36 incurred for the production or collection of income or for the management, conservation or maintenance of property held for the production of income.

5. The facts upon which petitioner relies as the basis for this proceeding are as follows:

(a) Petitioner deducted from gross income on line 14 of her Income Tax Return (Form 1040) for the calendar year 1938, interest in the total sum of \$8,717.33, which said total sum included interest in the amount of \$7,213.96 paid by petitioner to the Collector of Internal Revenue during the calendar year 1938 under the circumstances hereinafter set forth.

(b) Petitioner is one of the two daughters of Grace S. Hamilton, who died on January 23, 1937, leaving an estate subject to probate with an appraised value at the date of death of \$144,429.26. The debts of decedent and administration expenses of said estate totalled \$129,006.92. Said decedent had made transfers prior to her death of a substantial portion of her property, and the Commissioner of Internal Revenue determined that a portion of said transfers was includible in the gross estate of said decedent and subject to federal estate tax. The federal estate tax payable by the estate of said decedent, including the taxable portion of

said transfers as finally determined by said Commissioner, was the sum of \$672,809.04.

(c) Petitioner and her sister were each transferees of one-half of said transfers made by said decedent prior to her death, including the taxable portion of said transfers as finally determined by said Commissioner in determining the amount of said federal estate tax as aforesaid, and petitioner as such transferee was personally liable for the payment of said tax.

(d) The federal estate tax shown to be due by the return (Form 706) filed for said estate was \$642,119.42 and said tax became due and payable on April 23, 1938. During the calendar year 1938 petitioner and her said sister paid to the Collector of Internal Revenue the tax shown to be due by said return in equal proportions as between themselves as follows:

\$150,114.01 on July 22nd;

\$99,981.83 on August 27th; and

\$392,123.58 on September 29th.

(e) On September 29, 1938, petitioner and her said sister, in equal proportions as between themselves, paid to the Collector of Internal Revenue the interest due on said federal estate tax, which interest amounted to \$14,427.92. Petitioner's proportion of said interest was the sum of \$7,213.96. The Commissioner has erroneously disallowed the deduction of said interest taken by petitioner on her income tax return as aforesaid.

(f) Petitioner deducted from gross income on

line 14 of her Income Tax Return (Form 1040) for the calendar year 1940 interest in the total sum of \$8,456.97, which said total sum included interest in the amount of \$2,250.25 paid by petitioner to the Collector of Internal Revenue during the calendar year 1940 and interest in the amount of \$3,023.48 paid to the State Treasurer of the State of California during the calendar year 1940 under the circumstances hereinafter set forth.

(g) During the calendar year 1940 said Commissioner determined that there was a deficiency in federal estate tax due from the estate of said decedent in the amount of \$39,270.78 and on June 18, 1940, petitioner and her said sister paid to the Collector of Internal Revenue said deficiency together with interest in the amount of \$4,500.51 in equal proportions as between themselves. Petitioner's proportion of said interest was the sum of \$2,250.25.

(h) The Inheritance Tax Appraiser of the State of California also determined that a portion of said transfers made by said decedent prior to her death was subject to state inheritance taxes, and said taxes became due and payable on January 23, 1939. The total amount of said taxes was the sum of \$182,857.20, one-half of said sum having been assessed on account of petitioner's interest in said estate and in said transfers, and in certain insurance moneys received by reason of the death of said decedent. On January 20, 1939, petitioner and her said sister, in equal proportions as between themselves, paid to the State Treasurer of the State

of California on account of said state inheritance taxes the sum of \$131,026.00. On September 23, 1940, petitioner and her said sister, in equal proportions as between themselves, paid to the said State Treasurer of the State of California the balance of said state inheritance taxes in the amount of \$51,831.20 together with interest thereon in the amount of \$6,046.97. Petitioner's proportion of said interest was the sum of \$3,023.48.

(i) The Commissioner has erroneously disallowed the deduction of said interest in the amount of \$2,250.25 paid to the Collector of Internal Revenue and said interest in the amount of \$3,023.48 paid to said State Treasurer, taken by petitioner on her income tax return as aforesaid.

(j) From January 1, 1938, to and including October 5, 1938, petitioner owned directly 978 shares of the capital stock of J. D. and A. B. Spreckels Company. During the remainder of 1938 and during the years 1939 and 1940, petitioner owned directly 6 shares of the capital stock of said corporation. On October 6, 1938, petitioner deposited with voting trustees 972 shares of the capital stock of said corporation, and during the remainder of 1938 and during the years 1939 and 1940 petitioner was the owner of voting trust certificates representing 972 shares of the capital stock of said corporation. During the years 1938, 1939 and 1940 petitioner was a beneficiary of a trust known as the Grace S. Hamilton Trust, Crocker First National Bank of San Francisco, et al.,

trustees (except that during a portion of 1938 American Trust Company of San Francisco, et al., were trustees) and as such beneficiary was entitled to receive one-half of the income of said trust during said years. Included in the assets of said trust during said years were voting trust certificates representing 1340 shares of the capital stock of J. D. and A. B. Spreckels Company.

(k) During the calendar year 1938 J. D. and A. B. Spreckels Company made distributions to its stockholders in the amount of \$42.50 per share. Petitioner received from said distributions the total sum of \$70,040.00 representing a distribution of \$42.50 per share on 1648 shares, of which 670 shares represented petitioner's one-half interest in the said Grace S. Hamilton Trust and the remainder represented shares owned directly, or as voting trust certificates. Petitioner reported on her Income Tax Return (Form 1040) for the calendar year 1938 said sum of \$70,040.00 as follows: \$22,005.00 (included in the sum of \$30,002.21) on line 2 as dividends received; \$19,560.00 (included in the sum of \$30,840.96) on line 7 as income distributed by the voting trustees; and \$28,475.00 on line 7 as income from said Grace S. Hamilton Trust.

(l) On March 28, 1941, petitioner filed a claim for refund (Form 843) of income taxes paid for the calendar year 1938 in the amount of \$6,703.76. Said claim for refund was based on the ground that all said cash distributions in the amount of

\$70,040.00 received by petitioner during the calendar year 1938 from J. D. and A. B. Spreckels Company, either directly or indirectly, constituted non-taxable distributions. The Commissioner has failed to allow any portion of said claim for refund.

(m) During the calendar year 1939 J. D. and A. B. Spreckels Company made distributions to its stockholders in the amount of \$55.00 per share. Petitioner reported the receipt of said distribution on her income tax return (Form 1040) for the year 1939 as follows: On line 2 (included in the sum of \$8,073.50) as dividends received directly on 6 shares, the amount of \$330.00; on line 7, as income distributed by the voting trustees, the sum of \$53,362.64 representing dividends received on 972 shares in the amount of \$53,460.00 less expenses in the amount of \$97.36; and on line 7, as income received from said Grace S. Hamilton Trust (included in the sum of \$38,589.54) the amount of \$36,850.00 representing dividends on 670 shares.

(n) On April 4, 1941, petitioner filed a claim for refund (Form 843) of income taxes paid for the calendar year 1939 in the amount of \$14,379.85. Said claim for refund was based on the ground that all said cash distributions in the amount of \$90,640.00 received by petitioner during the calendar year 1939 from J. D. and A. B. Spreckels Company, either directly or indirectly, constituted non-taxable distributions. The Commissioner has failed to allow any portion of said claim for refund.

(o) During the calendar year 1940 J. D. and A. B. Spreckels Company made distributions to its

stockholders in the amount of \$68.00 per share. Petitioner received, either directly or indirectly, from said distributions the sum of \$112,064.00. On her Income Tax Return (Form 1040) for the calendar year 1940, petitioner excluded 82% of said distributions as non-taxable distributions and reported the remaining 18% thereof as follows: On line 2 (included in the sum of \$1,243.74) as dividends received directly on 6 shares the amount of \$73.44; on line 7, as income distributed by the voting trustees, the sum of \$11,799.92 representing dividends received on 972 shares in the amount of \$11,897.28 less expenses in the amount of \$97.36; and on line 7, as income received from said Grace S. Hamilton Trust (included in the sum of \$10,327.56) the amount of \$8,200.80 representing dividends on 670 shares.

(p) The Commissioner has erroneously increased petitioner's dividend income reported on line 2 of her said return by the amount of \$334.56, and has erroneously increased petitioner's fiduciary income reported on line 7 of her return by the amount of \$91,557.92. The total of said adjustments in the amount of \$91,892.48 represents 82% of the distributions received by petitioner, either directly or indirectly, from J. D. and A. B. Spreckels Company during the calendar year 1940 and which petitioner did not report on the ground that such distributions constituted non-taxable distributions as aforesaid.

(q) Petitioner alleges that no part of the cash distributions in the sum of \$70,040.00 received by

petitioner, either directly or indirectly, during the calendar year 1938 from said J. D. and A. B. Spreckels Company was paid out of the earnings or profits of said corporation accumulated after February 28, 1913, or out of earnings or profits for the calendar year 1938, and that said cash distributions were not subject to income tax in the hands of and were not taxable to petitioner.

(r) Petitioner alleges that only a portion of said cash distributions in the sum of \$90,640.00 received by petitioner, either directly or indirectly, during the calendar year 1939 from said J. D. and A. B. Spreckels Company, to wit: the sum of not more than \$49,683.41 was paid out of the earnings or profits of said corporation accumulated after February 28, 1913, or out of its earnings or profits for the calendar year 1939, and that the balance of said sum of \$90,640.00, to wit: an amount not less than the sum of \$40,956.59 was not paid out of the earnings or profits of said corporation accumulated after February 28, 1913, nor out of its earnings or profits for the taxable year 1939, and that said balance was not subject to income tax in the hands of and was not taxable to petitioner.

(s) Petitioner alleges that only a portion of said cash distributions in the sum of \$112,064.00 received by petitioner, either directly or indirectly, during the calendar year 1940 from said J. D. and A. B. Spreckels Company, to wit: the sum of not more than \$22,645.89 was paid out of the earnings or profits of said corporation accumulated after

February 28, 1913, or out of its earnings or profits for the calendar year 1940, and that the balance of said sum of \$112,064.00, to wit: an amount not less than the sum of \$89,418.11, was not paid out of the earnings or profits of said corporation accumulated after February 28, 1913, nor out of its earnings or profits for the taxable year 1940, and that said balance was not subject to income tax in the hands of and was not taxable to petitioner.

(t) Petitioner is informed and believes, and therefore alleges, that on January 1, 1938, J. D. and A. B. Spreckels Company had no earnings or profits accumulated since March 1, 1913, that its earnings or profits for the calendar years 1938, 1939 and 1940 did not exceed the amounts set forth below, and that the distributions to its stockholders made by said corporation during said years were as follows:

Year	Earnings or Profits	Distributions
1938	(Loss) \$1,313,516.91	850,000.00
1939	602,954.70	1,100,000.00
1940	274,827.56	1,360,000.00

(u) The basis to petitioner on January 1, 1938, for income tax purposes, of each share of the capital stock of J. D. and A. B. Spreckels Company, and of each share of said stock represented by voting trust certificates, held by said petitioner during the calendar years 1938, 1939 and 1940 was greater than the aggregate cash distributions made by said corporation during said three year period

on each of said shares. The basis to said Grace S. Hamilton Trust on January 1, 1938, for income tax purposes, of each share of said stock represented by voting trust certificates held by said trust during the calendar years 1938, 1939 and 1940 was greater than the aggregate cash distributions made by said corporation during said three year period on each of said shares.

(v) During the calendar year 1938 petitioner paid to Crocker First National Bank of San Francisco, as her proportion of the fee for acting as the agent of said voting trustees, the sum of \$97.36, and petitioner paid to a bookkeeper for keeping accounts of her financial affairs during the calendar year 1938 the sum of \$125.00.

Wherefore, petitioner prays that this Court may hear this proceeding and determine that petitioner is entitled to a refund of income taxes paid for the calendar year 1938 of at least \$6,703.76; that petitioner is entitled to a refund of income taxes paid for the calendar year 1939 of at least \$13,975.37; and that the deficiency in income tax for the calendar year 1940 does not exceed \$166.81.

/s/ LEON DE FREMERY,

Counsel for Petitioner.

State of California,

City and County of San Francisco—ss.

Leila H. Neill, being duly sworn, says:

That she is the petitioner above named; that she has read the foregoing petition, or had the same read to her, is familiar with the statements contained therein, and that the statements contained

therein are true, except those stated to be upon information and belief, and those she believes to be true.

/s/ LEILA H. NEILL.

Subscribed and sworn to before me this 7th day of June, 1944.

[Seal] /s/ W. W. HEALEY,
Notary Public in and for the City and County of
San Francisco, State of California.

EXHIBIT A

Treasury Department
Internal Revenue Service
74 New Montgomery Street
San Francisco 26, California

Office of
Internal Revenue Agent in Charge
San Francisco Division
IRA :90-D-LB
(C:TS:PD
SF:WGW)

May 26, 1944

Mrs. Leila H. Neill
1110 Crocker Building
San Francisco, California

Dear Mrs. Neill:

You are advised that the determination of your income tax liability for the taxable years 1938, 1939 and 1940 discloses a deficiency of \$49,994.48 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency mentioned.

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with The Tax Court of the United States for a redetermination of the deficiency.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Internal Revenue Agent in Charge, San Francisco 5, California, for the attention of—Conference Section. The signing and filing of this form will expedite the closing of your return(s) by permitting an early assessment of the deficiency, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,

JOSEPH D. NUNAN, JR.,

Commissioner.

By F. M. HARLESS,

Internal Revenue Agent

in Charge.

HJB

Enclosures:

Statement

Form of Waiver.

Statement

San Francisco
 IRA: 90-D-LB
 (C:TS:PD
 SF:WGW)

Mrs. Leila H. Neill
 1110 Crocker Building
 San Francisco, California

Tax Liability for the Taxable Years Ended December 31, 1938,
 December 31, 1939, and December 31, 1940

Year	Income Tax Liability	Assessed	Deficiency
1938.....	\$ 9,694.00	\$ 6,703.76	\$ 2,990.24
1939.....	14,621.90	14,379.85	242.05
1940.....	46,874.05	111.86	46,762.19
Totals	\$71,189.95	\$21,195.47	\$49,994.48

In making this determination of your income tax liability, careful consideration has been given to your protests dated May 28, 1941, and March 10, 1943, and to the statements made at the conferences held on February 2, 1942, May 20, 1942, September 11, 1942, April 30, 1943, February 15, 1944, and February 23, 1944. Consideration has also been given your claims for refund filed on March 29, 1941, for \$6,703.76 covering the year 1938; and April 5, 1941, for \$14,379.85 covering the year 1939.

If a petition to The Tax Court of the United States is filed against the deficiency proposed herein the issues set forth in your claims for 1938 and 1939 tax should be made a part of the petition to be considered by the Court in any redetermination of your tax liability. If a petition is not filed, the claims for refund will be disallowed and official notice will be issued by registered mail in accordance with existing internal revenue laws.

A copy of this letter and statement has been mailed to your representative, Mr. Leon de Fremery, 1110 Crocker Building, San Francisco, California, in accordance with the authority contained in the power of attorney executed by you and on file in this office.

You contend that your share of distributions by J. D. and A. B. Spreckels Company, a corporation, in which you owned stock directly and in which trusts, of which you were a beneficiary, owned stock is not taxable as a dividend in the year 1938, and that your share for the years 1939 and 1940 is taxable in part only. In the years 1938 and 1939 you reported the full distributions as taxable income. In the year 1940, you reported only 18 per cent as taxable. It is held that the distributions are out of earnings and profits accumulated after February 28, 1913, and are taxable as dividends in their entirety.

Adjustments to Net Income

Year: 1938

Net income as disclosed by return.....	\$41,874.49
Unallowable deductions and additional income:	
(a) Interest	\$7,213.96
(b) Other expense	222.36 7,436.32
Net income adjusted	<u>\$39,310.81</u>

Explanation of Adjustments

(a) You claimed on your income tax return for 1938, a deduction of \$7,213.96 for interest upon a deficiency in estate tax in the Estate of Grace S. Hamilton, Deceased. It is held that said amount was not paid on your indebtedness and is not deductible. See section 23(b) of the Revenue Act of 1938.

(b) The deduction of \$222.36 for fees and other expenses shown on line 18 of your return is disallowed since they do not constitute ordinary and necessary business expense and no other basis for the deduction has been established.

Computation of Alternative Tax

Year: 1938

(Section 117 (c)—Revenue Act of 1938)

Net income	\$49,310.81
Plus: Net long-term capital loss	18,007.86
Ordinary net income	<u>\$67,318.67</u>
Less: Personal exemption	\$2,500.00
Credit for dependents	566.87 3,066.67
Balance (surtax net income).....	<u>\$64,252.00</u>
Less: Earned income credit	300.00
Net income subject to normal tax.....	<u>\$63,952.00</u>
Normal tax at 4 per cent on \$63,952.00.....	\$ 2,558.08
Surtax on \$64,252.00.....	12,538.28
Partial tax	<u>\$15,096.36</u>
Minus: 30 per cent of net long-term loss.....	5,402.36
Alternative tax	<u>\$ 9,694.00</u>

Computation of Tax

Year: 1938

Net income adjusted	\$49,310.81
Less: Personal exemption	\$2,500.00
Credit for dependents	566.67 3,066.67
Balance (surtax net income)	\$46,244.14
Less: Earned income credit	300.00
Net income subject to normal tax	\$45,944.14
Normal tax at 4 per cent on \$45,944.14	\$ 1,837.77
Surtax on \$46,244.14	6,685.92
Total tax (ordinary rates)	\$ 8,523.69
Alternative tax	\$ 9,694.00
Correct income tax liability	\$ 9,694.00
Income tax assessed: Original, account No. 201571—	
First California District	6,703.76
Deficiency of income tax	\$ 2,990.24

Adjustments to Net Income

Year: 1939

Net income as disclosed by return	\$50,888.44
Unallowable deductions and additional income:	
(a) Rental income	440.08
Net income adjusted	\$51,328.52

Explanation of Adjustments

(a) Rentals of \$452.38 at item 8 of your return represented a net balance after deducting \$440.08 for depreciation on furniture in a rented apartment. Such deduction was in error since furniture had been removed from the apartment in 1939 and no deductible depreciation was sustained.

Computation of Alternative Tax

Year: 1939

(Section 117 (c)—Internal Revenue Code)

Net income		\$51,328.52
Plus: Net long-term capital loss		38,472.86
Ordinary net income		\$89,801.38
Less: Personal exemption	\$2,500.00	
Credit for dependents	800.00	3,300.00
Balance (surtax net income)		\$86,501.38
Less: Earned income credit		300.00
Net income subject to normal tax.....		\$86,201.38
Normal tax at 4 per cent on \$86,201.38.....		\$ 3,448.06
Surtax on \$86,501.38.....		22,715.70
Partial tax		\$26,163.76
Minus: 30 per cent of net long-term loss		11,541.86
Alternative tax		\$14,621.90

Computation of Tax

Year: 1939

Net income adjusted		\$51,328.52
Less: Personal exemption	\$2,500.00	
Credit for dependents	800.00	3,300.00
Balance (surtax net income)		\$48,028.52
Less: Earned income credit		300.00
Net income subject to normal tax		\$47,728.52
Normal tax at 4 per cent on \$47,728.52.....		\$ 1,909.14
Surtax on \$48,028.52.....		7,167.70
Total tax (ordinary rates).....		\$ 9,076.84
Alternative tax		\$14,621.90
Correct income tax liability.....		\$14,621.90
Income tax assessed: Original, account No. 200686—		
First California District		14,379.85
Deficiency of income tax.....		\$ 242.05

Adjustments to Net Income

Year: 1940

Net income as disclosed by return.....	\$	5,642.32
Unallowable deductions and additional income:		
(a) Dividends	\$	334.56
(b) Fiduciary income		91,566.97
(c) Interest disallowed		5,273.73
		<u>97,175.26</u>
Net income adjusted	\$	102,817.58

Explanation of Adjustments

(a) Dividends of \$1,243.74 shown on your return included only \$73.44 out of total dividends of \$408.00 received directly from the J. D. and A. B. Spreckels Co. The balance of \$334.56 was omitted by you on the basis of your contention that 82 per cent of the distribution was nontaxable. The entire amount is considered taxable and your net income is increased accordingly.

(b) Fiduciary income reportable by you is revised as follows:		
From Crocker First National Bank, agent for		
Voting Trustees of J. D. and A. B. Spreckels		
Co., as per your return.....		
	\$11,799.92	
Add: 82 per cent of \$66,096.00, portion of		
dividends from J. D. and A. B. Spreckels		
Co. omitted from your return.....		
	54,198.72	\$ 65,998.64
From Trust u/d Grace S. Hamilton, as		
shown on your return		
	\$10,327.56	
Add: 82 per cent of \$45,560.00, portion of		
dividends from J. D. and A. B. Spreckels		
Co. omitted from your return.....		
	37,359.20	
Trustee's expense allocable to exempt interest		
under section 24(a) (5), Internal		
Revenue Code		
	9.05	

Your share of trust income as revised.....	47,695.81
Total fiduciary income as revised.....	\$113,694.45
Fiduciary income as reported on return.....	<u>22,127.48</u>
Increase in fiduciary income.....	\$ 91,566.97

(c) You claimed on your income tax return for 1940 deductions for interest upon deficiencies in federal estate tax and state inheritance tax, in the amounts of \$2,250.25 and \$3,023.48, respectively, said amounts relating to the estate of Grace S. Hamilton, Deceased. It is held that the above-mentioned amounts aggregating \$5,273.73 were not paid on your indebtedness and are not deductible. See Section 23(b) of the Internal Revenue Code.

Computation of Alternative Tax

Year: 1940

(Section 117 (c)—Internal Revenue Code)

Net income	\$102,817.58
Plus: Net long-term capital loss	5,730.83
Ordinary net income	\$108,548.41
Less: Personal exemption	\$2,000.00
Credit for dependents	800.00 2,800.00
Balance (surtax net income)	\$105,748.41
Less: Earned income credit	300.00
Net income subject to normal tax	\$105,448.41
Normal tax at 4 per cent on \$105,448.41	\$ 4,217.94
Surtax on \$105,748.41	40,114.08
Partial tax	\$ 44,332.02
Minus: 30 per cent of net long-term loss	1,719.25
Alternative tax	\$ 42,612.77

Computation of Tax

Year: 1940

Net income adjusted	\$102,817.58
Less: Personal exemption	\$2,000.00
Credit for dependents	800.00 2,800.00
Balance (surtax net income)	\$100,017.58
Less: Earned income credit	300.00
Net income subject to normal tax	\$ 99,717.58
Normal tax at 4 per cent on \$ 99,717.58	\$ 3,988.70
Surtax on \$100,017.58	36,790.20
Total tax (ordinary rates)	\$ 40,778.90
Alternative tax	\$ 42,612.77
Add: Defense tax 10 per cent	4,261.28
Correct income tax liability	\$ 46,874.05
Income tax assessed: Original, account No. 855968—	
First California District	111.86
Deficiency of income tax	\$ 46,762.19

Received and Filed June 12, 1944, T.C.U.S.

[Title of Tax Court and Cause.]

Docket No. 5334

ANSWER

Comes now the Commissioner of Internal Revenue, respondent above named, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition filed by the above-named petitioner, admits and denies as follows:

1. Admits the allegations contained in paragraph 1 of the petition.

2. Admits the allegations contained in paragraph 2 of the petition.

3. Admits that the taxes in controversy are income taxes for the calendar years 1938, 1939 and 1940; denies all other allegations contained in paragraph 3 of the petition.

4. (a) to (f), inclusive. Denies that the determination of tax set forth in the notice of deficiency is based upon errors as alleged in paragraph 4 and subparagraphs (a) to (f), inclusive, thereunder of the petition.

5. (a) Admits that the petitioner deducted from gross income on line 14 of her income tax return (Form 1040) for the calendar year 1938, interest in the total sum of \$8,717.33; for lack of information and belief, denies all other allegations

contained in subparagraph (a) of paragraph 5 of the petition.

(b) Admits that petitioner is one of the daughters of Grace S. Hamilton, who died during 1937, leaving an estate subject to probate; for lack of information and belief, denies all other allegations contained in subparagraph (b) of paragraph 5 of the petition.

(c), (d) and (e). For lack of information and belief, denies all allegations contained in subparagraphs (c), (d) and (e) of paragraph 5 of the petition.

(f) Admits that petitioner deducted from gross income on line 14 of her income tax return (Form 1040) for the calendar year 1940 interest in the total sum of \$8,456.97; for lack of information and belief, denies all other allegations contained in subparagraph (f) of paragraph 5 of the petition.

(g) Admits that during the calendar year 1940 said Commissioner determined that there was a deficiency in Federal estate tax due from the estate of said decedent; for lack of information and belief, denies all other allegations contained in subparagraph (g) of paragraph 5 of the petition.

(h) For lack of information and belief, denies all allegations contained in subparagraph (h) of paragraph 5 of the petition.

(i) Denies the allegations contained in subparagraph (i) of paragraph 5 of the petition.

(j) Admits that during 1938 petitioner owned shares of capital stock of J. D. and A. B. Spreckels

Company; admits that during 1938, 1939 and 1940 petitioner was the owner of trust certificates representing shares of the capital stock of said corporation; admits that during the years 1938, 1939 and 1940 petitioner was a beneficiary of a trust known as the Grace S. Hamilton Trust, Crocker First National Bank of San Francisco, et al., Trustees, and as such beneficiary was entitled to receive income of said trust during said years; admits that included in the assets of said trust during said years were trust certificates representing shares of the capital stock of J. D. and A. B. Spreckels Company; for lack of information and belief, denies all other allegations contained in subparagraph (j) of paragraph 5 of the petition.

(k) Admits that during the calendar year 1938 J. D. and A. B. Spreckels Company made distributions to its stockholders; admits that petitioner received certain of said distributions; for lack of information and belief, denies all other allegations contained in subparagraph (k) of paragraph 5 of the petition.

(1) Admits that on March 28, 1941, petitioner filed a claim for refund (Form 843) of income taxes for the calendar year 1938 in the amount of \$6,703.76; admits that the Commissioner has failed to allow any portion of said claim for refund; for lack of information and belief, denies all other allegations contained in subparagraph (1) of paragraph 5 of the petition.

(m) Admits that during the calendar year 1939

J. D. and A. B. Spreckels Company made distributions to its stockholders; for lack of information and belief, denies all other allegations contained in subparagraph (m) of paragraph 5 of the petition.

(n) Admits that on April 4, 1941, petitioner filed a claim for refund (Form 843) of income taxes for the calendar year 1939 in the amount of \$14,379.85; admits that the Commissioner has failed to allow any portion of said claim for refund; for lack of information and belief, denies all other allegations contained in subparagraph (n) of paragraph 5 of the petition.

(o) Admits that during the calendar year 1940 J. D. and A. B. Spreckels Company made distributions to its stockholders; admits that petitioner received certain of said distributions and that on her income tax return (Form 1040) for the calendar year 1940 she excluded portions of said distributions on the theory that such portions were non-taxable; for lack of information and belief, denies all other allegations contained in subparagraph (o) of paragraph 5 of the petition.

(p) Admits that the Commissioner has increased petitioner's dividend income reported on line 2 of her said return by the amount of \$34.56, and has increased petitioner's fiduciary income reported on line 7 of her return by approximately \$91,557.92, but denies that said increases were made erroneously; for lack of information and belief, denies all other allegations contained in subparagraph (p) of paragraph 5 of the petition.

(q) to (t), inclusive. Denies the allegations contained in subparagraphs (q) to (t), inclusive, of paragraph 5 of the petition.

(u) and (v) For lack of information and belief, denies all allegations contained in subparagraphs (u) and (v) of paragraph 5 of the petition.

6. Denies generally and specifically each and every allegation in the petition not hereinbefore admitted, qualified, or denied.

Wherefore, it is prayed that the Commissioner's determination be approved and the petitioner's appeal denied.

/s/ J. P. WENCHEL,

Chief Counsel, Bureau of
Internal Revenue.

Of Counsel:

B. H. NEBLETT,

Division Counsel,

T. M. MATHER,

ARTHUR L. MURRAY,

Special Attorneys,

Bureau of Internal Revenue.

Received and filed July 24, 1944, T.C.U.S.

[Title of Tax Court and Cause.]

Docket No. 5334

SUPPLEMENTARY STIPULATION OF FACTS

It Is Hereby Stipulated and Agreed by and between the parties hereto, by their respective attorneys, that the following facts shall be taken as true upon the trial of the above-entitled case, provided, however, that this stipulation shall be without prejudice to the right of either party to introduce other and further evidence not inconsistent with the facts herein stipulated to be taken as true.

1. It is agreed that during the calendar year 1938 petitioner paid the sum of \$7,213.96 as interest and that said sum is allowable in full as a deduction in computing petitioner's taxable income for said year.

2. It is agreed that during the calendar year 1940 petitioner paid the sum of \$5,273.73 as interest and that said sum is allowable in full as a deduction in computing petitioner's taxable income for said year.

3. It is agreed that during the calendar year 1938 petitioner paid the sum of \$222.36 incurred for the production or collection of income or for the management, conservation or maintenance of property held for the production of income and that said sum is allowable in full as a deduction in computing petitioner's taxable income for said year.

4. From January 1, 1938, to and including October 5, 1938, petitioner owned directly 978 shares of the capital stock of J. D. and A. B. Spreckels Company issued to and standing in her name. During the remainder of 1938 and during the entire calendar years 1939 and 1940 petitioner owned directly 6 shares of the capital stock of said company standing in her own name. On October 6, 1938, petitioner deposited with voting trustees 972 shares of the capital stock of said company and during the remainder of 1938 and during the entire calendar years 1939 and 1940 petitioner was the owner of voting trust certificates representing 972 shares of the capital stock of said company. Petitioner received from said company distributions on said shares in the following amounts:

Schedule A			
Year	From Shares Standing in Her Own Name	From	Total
		Shares Covered by Said Voting Trust Certificates	
1/ 1/38 to 12/15/38.....	\$22,050.00	\$ 7,290.00	\$29,340.00
12/22/38	75.00	12,150.00	12,225.00
Total 1938	\$22,125.00	\$19,440.00	\$41,565.00
1939	330.00	53,460.00	53,790.00
1940	408.00	66,096.00	66,504.00

At all times during the calendar years 1938, 1939 and 1940 petitioner was a beneficiary of a trust known as the Grace S. Hamilton Trust, Crocker First National Bank of San Francisco, et al., Trustees, and as such beneficiary was entitled to receive one-half of the income of said trust for said years. Included in the assets of said trust for said

years were voting trust certificates representing 1,340 shares of the capital stock of J. D. and A. B. Spreckels Company. The distributions received by the trustees from said company were, under the terms of the trust, after deducting certain prior charges and expenses of the trust, currently distributable to the beneficiary. During said years the trustees made distributions as required by the terms of the trust and petitioner received from the trustees as petitioner's net share of said distributions of J. D. and A. B. Spreckels Company on said 1,340 shares the following amounts:

Schedule B

Year	Net Distribution by Trustees	J. D. and A. B. Spreckels Company Dividends	Net Bal. of Other Items
1/1/38 to 12/15/38		\$20,100.00	
12/22/38		8,375.00	
Total 1938	\$28,627.13	\$28,475.00	\$ 152.13
1939	\$38,589.54	\$36,850.00	\$1,739.54
1940	\$47,695.81	\$45,560.00	\$2,135.81

The parties are agreed that the portions of the dividends of J. D. and A. B. Spreckels Company for the years 1938, 1939 and 1940 which this Court determines in the case of *Grace H. Kelham, Petitioner, vs. Commissioner of Internal Revenue, Respondent*, Docket No. 5333, have been paid out of capital will, in the case of this petitioner, represent: (a) The portions of the respective amounts listed in the "Total" column of Schedule A which will be eliminated from the petitioner's taxable income for the years 1938, 1939 and 1940; and (b) the portions of the respective amounts listed in the

column entitled "J. D. and A. B. Spreckels Company Dividends" of Schedule B which are to be subtracted from the respective amounts listed in the column entitled "Net Distribution by Trustees" of Schedule B in determining petitioner's taxable income for the years 1938, 1939 and 1940.

Dated this 31st day of October, 1947.

/s/ LEON de FREMERY,
Attorney for Petitioner.

/s/ CHARLES OLIPHANT,
Chief Counsel, Bureau of
Internal Revenue.

Filed at hearing Nov. 3, 1947, T.C.U.S.

The Tax Court of the United States,
Washington
Docket No. 5334

LEILA H. NEILL,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DECISION

Pursuant to the Court's Findings of Fact and Opinion, promulgated December 20, 1949, the respondent herein filed a computation of tax on February 28, 1950, and the petitioner on the same date

filed an acquiescence in the respondent's computation. In accordance therewith it is

Ordered and Decided: That for the year 1938 there is an overpayment in income tax of \$4,058.66, which amount was paid after the mailing of the notice of deficiency;

That for the 1939 there is an over-payment in income tax of \$14,287.93, a portion of which amount was paid within two years before the filing of claim for refund and the remainder was paid after the mailing of the notice of deficiency;

That for the year 1940 there is an over-payment in income tax of \$57,429.30, which amount was paid after the mailing of the notice of deficiency.

Enter:

/s/ BOLON B. TURNER,
Judge.

Entered Mar. 14, 1950.

Served Mar. 15, 1950.

In the United States Court of Appeals
For the Ninth Circuit

T. C. Docket No. 5334

COMMISSIONER OF INTERNAL REVENUE,

Petitioner on Review,

vs.

LEILA H. NEILL,

Respondent on Review.

PETITION FOR REVIEW

To the Honorable Judges of the United States
Court of Appeals for the Ninth Circuit:

The Commissioner of Internal Revenue hereby petitions the United States Court of Appeals for the Ninth Circuit to review the decision entered by the Tax Court of the United States on March 14, 1950, that there are overpayments in income taxes for the years 1939 and 1940 in the respective amounts of \$14,287.93 and \$57,429.30 in respect of the Federal income tax liability of Leila H. Neill, the above-named respondent on review. This petition for review is filed pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code.

The respondent on review, Leila H. Neill, is a resident of California whose mailing address is 1110 Crocker Building, San Francisco, California. Respondent's Federal income tax returns for the calendar years 1939 and 1940, the taxable years here involved, were filed with the Collector of In-

ternal Revenue for the First District of California, whose office is located in San Francisco, California, and within the jurisdiction of the United States Court of Appeals for the Ninth Circuit where this review is sought.

Nature of Controversy

From January 1, 1938, to and including October 5, 1938, the respondent on review was the owner of 978 shares of stock of J. D. and A. B. Spreckels Company. During the remainder of 1938 and during the years 1939 and 1940 the respondent on review owned directly 6 shares of the capital stock of said company and voting trust certificates representing 972 shares of the capital stock of said company. During the years 1938, 1939 and 1940 respondent received distributions from the J. D. and A. B. Spreckels Company in respect of said shares and voting trust certificates the respective aggregate sums of \$41,565.00, \$53,790.00 and \$66,504.00. The respondent was also the beneficiary of a trust among the assets of which trust were voting trust certificates representing 1,340 shares of the capital stock of J. D. and A. B. Spreckels Company. As a part of her share of the distributable income of said trust for the years 1938, 1939 and 1940, the respondent received from the trustees, as her net share of distributions made to the trust by the J. D. and A. B. Spreckels Company during those years on said 1,340 shares, the respective sums of \$28,475.00, \$36,850.00 and \$45,560.00. In her Federal income tax returns for the years 1939 and

1940, the respondent returned as taxable income the amounts so received in 1939 but only \$11,799.92 in 1940 in respect of the voting trust certificates of J. D. and A. B. Spreckels Company owned directly by her and only \$10,327.56 in respect of her share of distributions made to the trust. All of the distributions received by the respondent in 1938 were reported as taxable income in her 1938 return. In his redetermination of the respondent's tax liability for the year 1940 the Commissioner increased the distributions returned by the respondent to their full amounts. There is now no dispute in respect of the year 1938.

In was the taxpayer's contention before the Tax Court of the United States, among other things, that in determining the percentages or amounts of the distributions made by the J. D. and A. B. Spreckels Company which represented taxable dividends in the hands of the recipients thereof it is necessary to first restore out of subsequent earnings and profits the pre-March 1, 1913, accumulated operating losses, or deficit, of the predecessor of J. D. and A. B. Spreckels Company and its affiliated companies. The Commissioner contended, on the other hand, that operating deficits as of March 1, 1913, may not be restored by subsequent earnings and profits in determining the amount of earnings or profits accumulated after February 28, 1913, which would constitute taxable dividends to the recipients in whole or in part. The Tax Court of the United States disagreed with the Commission-

er's determination and allowed the restoration of pre-March 1, 1913, accumulated operating losses for the purpose of determining the amount of subsequent earnings and profits available for distribution as taxable dividends, as a result of which allowances the overpayments of tax for the years 1939 and 1940 partly resulted.

/s/ THERON L. CAUDLE,
Assistant Attorney General.

/s/ CHARLES OLIPHANT,
Chief Counsel, Bureau of Internal Revenue, Attorneys for Petitioner on Review.

Received and filed June 2, 1950. T.C.U.S.

The Tax Court of the United States

Docket No. 5495

ELLIS M. MOORE,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (San Francisco—IRA:90D-LB) dated

May 26, 1944, and as a basis of her proceeding alleges as follows:

1. Petitioner is an individual, whose mailing address is 1110 Crocker Building, San Francisco, California. The returns for the periods here involved were filed with the Collector for the First District of California.

2. The notice of deficiency (a copy of which is attached hereto and marked "Exhibit A") was mailed to petitioner on May 26, 1944.

3. The taxes in controversy are income taxes for the calendar years 1937, 1938, 1939 and 1940 and in the following amounts:

Year	Deficiency Asserted	Overpayment Claimed	Amount in Controversy
1937.....	\$ 6,989.38	\$10,436.63	\$17,426.01
1938.....	3,274.99	5,723.26	8,998.25
1939.....	2,744.62	7,324.66	10,069.28
1940.....	23,499.16	None	23,415.80

4. The determination of tax set forth in said notice of deficiency is based upon the following errors:

(a) The Commissioner erred in including in petitioner's income subject to tax for the calendar years 1937, 1938 and for the period January 1 to August 31, 1939, one-half of her husband's income from a professional partnership, of which he was a member, and in failing to find that no portion of said income was community income and taxable to petitioner.

(b) The Commissioner erred in determining

that distributions made by J. D. and A. B. Spreckels Company to its stockholders during the calendar year 1937 were paid out of earnings or profits to the extent of 100% thereof, and the Commissioner erred in failing to find that at least 28.522% of said distributions were not paid out of earnings or profits, and in failing to allow to that extent petitioner's claim for refund of income taxes paid for the calendar year 1937.

(c) The Commissioner erred in determining that distributions made by J. D. and A. B. Spreckels Company to its stockholders during the calendar year 1938 were paid out of earnings or profits to the extent of 100% thereof, and that the Commissioner erred in failing to find that no portion of said distributions were paid out of earnings or profits, and in failing to allow in full petitioner's claim for refund of income taxes paid for the calendar year 1938.

(d) The Commissioner erred in determining that distributions made by J. D. and A. B. Spreckels Company to its stockholders during the calendar year 1939 were paid out of earnings or profits to the extent of 100% thereof, and the Commissioner erred in failing to find that at least 45.186% of said distributions were not paid out of earnings or profits, and in failing to allow to that extent petitioner's claim for refund of income taxes paid for the calendar year 1939.

(e) The Commissioner erred in determining that distributions made by J. D. and A. B. Spreck-

els Company to its stockholders during the calendar year 1940 were paid out of earnings or profits to the extent of 100% thereof, and as a result of said determination increasing petitioner's income for the year 1940 by the amount of \$57,932.99, and the Commissioner erred in failing to find that at least 79.792% of said distributions were not paid out of earnings or profits.

(f) The Commissioner erred in failing to allow as a deduction expenses incurred in the amount of \$1,200 during each of the years 1937, 1938, 1939 and 1940 for the production or collection of income or for the management, conservation or maintenance of property held for the production of income.

5. The facts upon which petitioner relies as the basis of this proceeding are as follows:

(a) Petitioner married Dr. E. Clarence Moore of Los Angeles, California, on October 20, 1936. Prior to their marriage and during the years here involved petitioner's husband was a practicing physician and derived his professional income from a partnership, of which he was a member, known as the Moore-White Clinic.

(b) Prior to their marriage petitioner and her said husband entered into an oral agreement, wherein it was provided, amongst other things, that all fees, salaries and other income earned or received after marriage for personal services or otherwise by either of them should be received as and be the separate property of the party earning or receiving such fees or salaries or other income. Said

oral agreement was reduced to writing on August 31, 1939.

(c) The Commissioner has erroneously added to petitioner's income for the calendar year 1937 the sum of \$13,078.99 alleged to be petitioner's community share of her said husband's partnership income.

(d) The Commissioner has erroneously added to petitioner's income for the calendar year 1938 the sum of \$11,571.79 alleged to be petitioner's community share of her said husband's partnership income.

(e) The Commissioner has erroneously added to petitioner's income for the calendar year 1939 the sum of \$7,381.38 alleged to be petitioner's community share of her said husband's partnership income for the period January 1 to August 31, 1939.

(f) During the calendar years 1937, 1938, 1939 and 1940 petitioner owned directly 2 shares of the capital stock of J. D. and A. B. Spreckels Company and voting trust certificates representing 498 shares of the capital stock of said corporation. During the years 1937, 1938, 1939 and 1940 petitioner was a beneficiary of a trust known as the Claus Spreckels Trust, Crocker First National Bank of San Francisco, Trustee, and as such beneficiary was entitled to receive 26/32nds of the income of said trust during the calendar year 1937 and for the period January 1 to and including September 26, 1938, and was entitled to receive 23/32nds of the income of said trust for the period September 27 to December 31, 1938, and during the calendar years 1939 and 1940.

Included in the assets of said trust during each of said years were voting trust certificates representing 752 shares of the capital stock of J. D. and A. B. Spreckels Company.

(g) During the calendar year 1937 J. D. and A. B. Spreckels Company made distributions to its stockholders in the amount of \$75.00 a share. With respect to petitioner's ownership of shares of stock and voting trust certificates as aforesaid, petitioner reported the receipt of said distributions on her income tax return (Form 1040) for the calendar year 1937 as follows: On line 2 (included in the sum of \$3,131.33) as dividends received directly on 2 shares, the sum of \$150.00; and on line 7, as income distributed by the voting trustees, the sum of \$37,291.17 representing dividends received on 498 shares in the amount of \$37,350.00 less expenses in the amount of \$58.83. Petitioner also reported on line 7 of said return, as income received from said Claus Spreckels Trust, the amount of \$45,207.43, which amount, due to the deduction of expenses, is somewhat less than petitioner's fractional interest in the distributions received from said J. D. and A. B. Spreckels Company by said trust. Petitioner filed said income tax return for the calendar year 1937 on March 15, 1938.

(h) On March 14, 1941, petitioner filed a claim for refund (Form 843) of income taxes paid for the calendar year 1937 in the amount of \$20,546.60. Said claim for refund was based on the ground that no portion of said cash distributions in the total amount of \$82,648.60 received by petitioner during

the calendar year 1937 from J. D. and A. B. Spreckels Company, either directly or indirectly, was paid out of the earnings or profits of said corporation but that all said distributions were paid out of capital, and were not subject to income tax. The Commissioner has failed to allow any portion of said claim for refund.

(i) During the period January 1 to and including September 26, 1938, J. D. and A. B. Spreckels Company made distributions to its stockholders in the amount of \$22.50 a share. During the period September 27 to and including December 31, 1938, J. D. and A. B. Spreckels Company made distributions to its stockholders in the amount of \$20.00 a share. With respect to petitioner's ownership of shares of stock and voting trust certificates as aforesaid, petitioner reported the receipt of said distributions on her income tax return (Form 1040) for the calendar year 1938 as follows: On line 2 (included in the sum of \$1,481.51) as dividends received directly on 2 shares the sum of \$85.00; and on line 7, as income distributed by the voting trustees, the sum of \$21,115.12, representing dividends received on 498 shares in the amount of \$21,165.00, less expenses in the amount of \$49.88. Petitioner also reported on line 7 of said return, as income received from said Claus Spreckels Trust, the amount of \$24,435.16, which amount, due to the deduction of expenses, is somewhat less than petitioner's fractional interest in the distributions received from said J. D. and A. B. Spreckels Company by said

trust. Petitioner filed said income tax return for the calendar year 1938 on March 15, 1939.

(j) On February 28, 1942, petitioner filed a claim for refund (Form 843) of income taxes paid for the calendar year 1938 in the amount of \$5,-723.26. Said claim for refund was based on the ground that no portion of said cash distributions in the total amount of \$45,635.28 received by petitioner during the calendar year 1938 from J. D. and A. B. Spreckels Company, either directly or indirectly, was paid out of the earnings or profits of J. D. and A. B. Spreckels Company for the taxable year 1938, nor out of the earnings or profits of said corporation accumulated after February 28, 1913, and that said distributions were not subject to income tax. The Commissioner has failed to allow any portion of said claim for refund.

(k) During the calendar year 1939 J. D. and A. B. Spreckels Company made distributions to its stockholders in the amount of \$55.00 a share. With respect to petitioner's ownership of shares of stock and voting trust certificates, as aforesaid, petitioner reported the receipt of said distributions on her income tax return (Form 1040) for the calendar year 1939 as follows: On line 2 (included in the sum of \$1,751.48), as dividends received directly on 2 shares, the sum of \$110.00; and one line 7, as income distributed by the voting trustees, the sum of \$27,-340.12, representing dividends received on 498 shares in the amount of \$27,390.00 less expenses in the amount of \$49.88. Petitioner also reported on line 7 of said return, as income received from said Claus

Spreckels Trust, the amount of \$29,426.45, which amount, due to the deduction of expenses, is somewhat less than petitioner's fractional interest in the distributions received from said J. D. and A. B. Spreckels Company by said trust. Petitioner filed said income tax return for the calendar year 1939 on March 14, 1940.

(1) On March 11, 1943, petitioner filed a claim for refund (Form 843) of income taxes paid for the calendar year 1939 in the amount of \$7,324.66. Said claim for refund was based on the ground that no portion of said cash distributions in the total amount of \$56,876.57 received by petitioner during the calendar year 1939 from J. D. and A. B. Spreckels Company, either directly or indirectly, was paid out of the earnings or profits of J. D. and A. B. Spreckels Company for the taxable year 1939, nor out of the earnings or profits of said corporation accumulated after February 28, 1913, and that said distributions were not subject to income tax. The Commissioner has failed to allow any portion of said claim for refund.

(m) During the calendar year 1940 J. D. and A. B. Spreckels Company made distributions to its stockholders in the amount of \$68.00 a share. Petitioner received directly on 2 shares the sum of \$136.00 and received as income distributed by the voting trustees the sum of \$33,814.12, representing dividends received by said voting trustees on 498 shares in the amount of \$33,864.00 less expenses in the amount of \$49.88. Petitioner excluded 82% of said distributions on her income tax return (Form

1040) for the calendar year 1940 as non-taxable distributions and reported \$6,111.02 representing the remaining 18% thereof (18% of \$33,950.12) on line 2 as dividends received. Petitioner received during the calendar year 1940 from said Claus Spreckels Trust the sum of \$36,413.65, which amount, due to the deduction of expenses, was somewhat less than petitioner's fractional interest in the distributions received from said J. D. and A. B. Spreckels Company by said trust. Petitioner excluded approximately 82% of said amount as non-taxable income and reported approximately 18% thereof, namely, \$6,319.76, on line 7 of her said income tax return as received from said Claus Spreckels Trust.

(n) The Commissioner has erroneously increased petitioner's dividend income reported on line 2 of her said return by the amount of \$27,839.10 and has erroneously increased petitioner's fiduciary income reported on line 7 of her return by the amount of \$30,093.89. The total of said adjustments in the amount of \$57,932.99 represents approximately 82% of the distributions received by petitioner, either directly or indirectly, from J. D. and A. B. Spreckels Company during the calendar year 1940 and which petitioner did not report on the ground that such part of said distributions constituted non-taxable distributions as aforesaid.

(o) Petitioner alleges that only a portion of said cash distributions in the sum of \$82,648.60 received by petitioner, either directly or indirectly, during the calendar year 1937 from J. D. and A. B.

Spreckels Company, to wit: the sum of not more than \$59,075.58, was paid out of the earnings or profits of said corporation accumulated after February 28, 1913, or out of earnings or profits for the calendar year 1937, and that the balance of said sum of \$82,648.60, to wit: an amount not less than the sum of \$23,573.02 was not paid out of the earnings or profits of said corporation accumulated after February 28, 1913, nor out of its earnings or profits for the taxable year 1937, and that said balance was not subject to income tax in the hands of and was not taxable to petitioner.

(p) Petitioner alleges that no part of said cash distributions in the sum of \$45,635.28 received by petitioner, either directly or indirectly, during the calendar year 1938 from J. D. and A. B. Spreckels Company was paid out of the earnings or profits of said corporation accumulated after February 28, 1913, or out of earnings or profits for the calendar year 1938, and that said cash distributions were not subject to income tax in the hands of and were not taxable to petitioner.

(q) Petitioner alleges that only a portion of said cash distributions in the sum of \$56,876.57 received by petitioner, either directly or indirectly, during the calendar year 1939 from J. D. and A. B. Spreckels Company, to wit: the sum of not more than \$31,176.32, was paid out of the earnings or profits of said corporation accumulated after February 28, 1913, or out of its earnings or profits for the calendar year 1939, and that the balance of said sum of \$56,876.57, to wit: an amount not less than

the sum of \$25,700.25, was not paid out of the earnings or profits of said corporation accumulated after February 28, 1913, nor out of its earnings or profits for the taxable year 1939, and that said balance was not subject to income tax in the hands of and was not taxable to petitioner.

(r) Petitioner alleges that only a portion of said cash distributions in the sum of \$70,363.77 received by petitioner, either directly or indirectly, during the calendar year 1940 from J. D. and A. B. Spreckels Company, to wit: the sum of not more than \$14,219.11, was paid out of the earnings or profits of said corporation accumulated after February 28, 1913, or out of its earnings or profits for the calendar year 1940, and that the balance of said sum of \$70,363.77, to wit: an amount not less than the sum of \$56,144.66, was not paid out of the earnings or profits of said corporation accumulated after February 28, 1913, nor out of its earnings or profits for the taxable year 1940 and that said balance was not subject to income tax in the hands of and was not taxable to petitioner.

(s) Petitioner is informed and believes, and therefore alleges, that on January 1, 1937, J. D. and A. B. Spreckels Company had no earnings or profits accumulated since March 1, 1913, that its earnings or profits for the calendar years 1937, 1938, 1939 and 1940 did not exceed the amounts set forth below, and that the distributions to its stockholders made by said corporation during said years were as follows:

Year	Earnings or Profits	Distributions
1937.....	\$1,072,164.11	\$1,500,000.00
1938.....(Loss)	1,313,516.91	850,000.00
1939.....	602,954.70	1,100,000.00
1940.....	274,827.56	1,360,000.00

(t) The basis to petitioner on January 1, 1937, for income tax purposes, of each share of the capital stock of J. D. and A. B. Spreckels Company, and of each share of said stock represented by voting trust certificates, held by said petitioner during the calendar years 1937, 1938, 1939 and 1940 was greater than the aggregate cash distributions made by said corporation during said four year period on each of said shares. The basis to said Claus Spreckels Trust on January 1, 1937, for income tax purposes, of each share of said stock represented by voting trust certificates held by said trust during the calendar years 1937, 1938, 1939 and 1940 was greater than the aggregate cash distributions made by said corporation during said four year period on each of said shares.

(u) Petitioner paid to Morrison, Hohfeld, Foerster, Shuman & Clark the sum of \$1,200 during each of the years 1937, 1938, 1939 and 1940 for investment counsel and for the maintenance of her financial records.

Wherefore, petitioner prays that this Court may hear this proceeding and determine that petitioner is entitled to a refund of income taxes paid for the calendar year 1937 in the amount of at least \$10,-436.63; that petitioner is entitled to a refund of

income taxes paid for the calendar year 1938 in the amount of at least \$5,723.26; that petitioner is entitled to a refund of income taxes paid for the calendar year 1939 in the amount of at least \$7,324.66; and that the deficiency in income taxes for the calendar year 1940 does not exceed \$83.36.

/s/ LEON de FREMERY,
Counsel for Petitioner.

State of California,
County of Los Angeles—ss.

Ellis M. Moore, being duly sworn, says that she is the petitioner above named; that she has read the foregoing petition, or had the same read to her, and is familiar with the statements contained therein, that the statements contained therein are true, except those stated to be upon information and belief, and those she believes to be true.

/s/ ELLIS M. MOORE.

Subscribed and sworn to before me this 28th day of June, 1944.

[Seal] /s/ HARRIETT R. BARKER,
Notary Public.

My commission expires January 26, 1946.

EXHIBIT A

Treasury Department
Internal Revenue Service
74 New Montgomery Street
San Francisco 5, California

Office of
Internal Revenue Agent in Charge
San Francisco Division

IRA:90-D-LB
(C:TS:PD
SF:WGW)

May 26, 1944

Mrs. Ellis M. Moore
1110 Crocker Building
San Francisco, California

Dear Mrs. Moore:

You are advised that the determination of your income tax liability for the taxable years 1937, 1938, 1939 and 1940 discloses a deficiency of \$36,508.15 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency mentioned.

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with The Tax Court of the United States for a redetermination of the deficiency.

Should you not desire to file a petition, you are

requested to execute the enclosed form and forward it to the Internal Revenue Agent in Charge, San Francisco 5, California, for the attention of Conference Section. The signing and filing of this form will expedite the closing of your returns by permitting an early assessment of the deficiency, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,

JOSEPH D. NUNAN, JR.,

Commissioner,

By F. M. HARLESS,

Internal Revenue Agent in
Charge.

HJB

Enclosures:

Statement

Form of waiver.

Statement

San Francisco
(C:TS:PD
SF:WGW)

Mrs. Ellis M. Moore
1110 Crocker Building
San Francisco, California

Tax Liability for the Taxable Years Ended December 31, 1937 to
December 31, 1940, Inclusive

Year	Income Tax Liability	Assessed	Deficiency
1937.....	\$27,535.98	\$20,546.60	\$ 6,989.38
1938.....	8,998.25	5,723.26	3,274.99
1939.....	13,500.92	10,756.30	2,744.62
1940.....	24,215.62	716.46	23,499.16
Totals	<u>\$74,250.77</u>	<u>\$37,742.62</u>	<u>\$36,508.15</u>

In making this determination of your income tax liability, careful consideration has been given to your protests dated January 21, 1943, and March 24, 1943, and to the statements made at the conferences held on March 16, 1943, March 17, 1943, April 30, 1943, February 15, 1944, and February 23, 1944. Consideration has also been given to your claims for refund filed on March 14, 1941, covering 1937 in the amount of \$20,546.60; February 28, 1942, covering 1938 in the amount of \$5,723.26 and March 11, 1943, covering 1939 in the amount of \$7,324.66.

If a petition to The Tax Court of the United States is filed against the deficiency proposed herein, the issue set forth in your claims for refund should be made a part of the petition to be considered by the Court in any redetermination of your tax liability. If a petition is not filed, the claims for refund will be disallowed and official notice will be issued by registered mail in accordance with existing internal revenue laws.

A copy of this letter and statement has been mailed to your representative, Mr. Leon de Fremery, 1110 Crocker Building, San Francisco, California, in accordance with the authority contained in the power of attorney executed by you and on file in this office.

You contend that your share of distributions by J. D. and A. B. Spreckels Company, a corporation, in which you owned stock directly and in which, trusts of which you were a beneficiary owned stock, is not taxable as a dividend in the year 1938, and that your share in the years 1937, 1939 and 1940 is taxable in part only. In the years 1937, 1938 and 1939 you reported the distributions as taxable income. In the year 1940 you reported only 18 per cent as taxable. It is held that

the distributions are out of earnings and profits accumulated after February 28, 1913, and are taxable as dividends in their entirety.

You contend that an oral agreement was entered into between yourself and your husband prior to your marriage on October 20, 1936, whereby it was agreed that your husband's income from his personal services would be his separate property. On August 31, 1939, a written agreement to that effect was signed by you and your husband. Information at hand indicates that during your marriage the matter of signing such an agreement was discussed and that for a considerable period of time you were reluctant to enter into a written agreement whereby you would waive your rights to the community income. In your income tax return for the year 1936, one-half of your husband's income from services from the time of your marriage to the end of the year, was returned by you and none was returned in the following years, separate returns having been filed in each year. It is held that one-half of your husband's income from services for the years 1937, 1938, and up to August 31, 1939, is includible in your taxable income.

Adjustments to Net Income

Year: 1937

Net income as disclosed by return.....	\$78,911.61
Unallowable deductions and additional income:	
(a) Community share of husband's partnership income.....	13,078.99
Net income adjusted.....	<u>\$91,990.60</u>

Explanation of Adjustments

(a) The distributive share of your husband, Dr. E. C. Moore, in the income less expenses of the Moore White Clinic, a partnership, for the year 1937, amounted to \$26,157.98 as shown by the separate return of your husband. In accordance with the preliminary statement herein it is held that one-half of your husband's income from services or **\$13,078.99 is includible in your taxable income.**

(b) Credit of \$105.40 for interest on Government obligations is allowed against the income subject to normal tax.

(c) Your allowable earned income credit is computed as follows:

Husband's partnership income, fully earned.....	\$26,157.98
Your one-half share—earned income.....	\$13,078.99
Earned income credit allowable (10 per cent of \$13,078.99)..<	\$ 1,307.90

Computation of Tax
Year: 1937

Net income adjusted		\$91,990.60
Less: Personal exemption	\$2,500.00	
Credit for dependent	400.00	2,900.00
Balance (surtax net income).....		\$89,090.60
Less: (b) Interest on U. S. obligations.....	\$ 105.40	
(c) Earned income credit	1,307.90	1,413.30
Net income subject to normal tax.....		\$87,677.30
Normal tax at 4 per cent on \$87,677.30.....		\$ 3,507.09
Surtax on	\$89,090.60	24,036.21
Total tax		\$27,543.30
Less: Income tax paid at the source.....		7.32
Correct income tax liability.....		\$27,535.98
Income tax assessed: Original, account No. 203144—		
First California District		20,546.60
Deficiency of income tax.....		\$ 6,989.38

Adjustments to Net Income
Year: 1938

Net income as disclosed by return.....	\$39,241.46
Unallowable deductions and additional income:	
(a) Community share of husband's partnership income.....	11,571.79
Net income adjusted.....	\$50,813.25

Explanation of Adjustments

(a) There is added to your taxable income \$11,571.79, representing your 50 per cent community share of \$23,143.58, the distributive income derived by your husband, Dr. E. C. Moore, from the Moore-White Clinic, a partnership, as shown by his separate return.

(b) Your allowable earned income credit is computed as follows:

Husband's partnership income, 100 per cent earned.....	\$23,143.58
Your one-half community share—earned income.....	\$11,571.79
Earned income credit (10 per cent of \$11,571.79).....	\$ 1,157.18

Computation of Alternative Tax
Year: 1938

(Section 117 (c)—Revenue Act of 1938)

Net income		\$50,813.25
Plus: Net long-term capital loss.....		153.25
Ordinary net income		<u>\$50,966.50</u>
Less: Personal exemption	\$2,500.00	
Credit for dependent.....	400.00	2,900.00
Balance (surtax net income).....		<u>\$48,066.50</u>
Less: Interest on Government obligations, etc.....	\$ 80.09	
Earned income credit.....	1,157.18	1,237.27
Net income subject to normal tax.....		<u>\$46,829.23</u>
Normal tax at 4 per cent on \$46,829.23.....		\$ 1,873.17
Surtax on \$48,066.50.....		7,177.96
Partial tax		<u>\$ 9,051.13</u>
Minus: 30 per cent of net long-term loss.....		45.98
Alternative tax		<u>\$ 9,005.15</u>

Computation of Tax
Year: 1938

Net income adjusted		\$50,813.25
Less: Personal exemption	\$2,500.00	
Credit for dependent	400.00	2,900.00
Balance (surtax net income)		<u>\$47,913.25</u>
Less: Interest on U. S. obligations.....	\$ 80.09	
(b) Earned income credit.....	1,157.18	1,237.27
Net income subject to normal tax.....		<u>\$46,675.98</u>
Normal tax at 4 per cent on \$46,675.98.....		\$ 1,867.04
Surtax on \$47,913.25.....		7,136.58
Total tax (ordinary rates)		<u>\$ 9,003.62</u>
Alternative tax		\$ 9,005.15
Less: Income tax paid at the source.....		6.90
Correct income tax liability.....		<u>\$ 8,998.25</u>
Income tax assessed: Original, account No. 203018—		
First California District		5,723.26
Deficiency of income tax.....		<u>\$ 3,274.99</u>

Adjustments to Net Income

Year: 1939

Net income as disclosed by return.....	\$55,983.28
Unallowable deductions and additional income:	
(a) Community share of husband's partnership income.....	7,381.38
Net income adjusted	<u>\$63,364.66</u>

Explanation of Adjustments

(a) There is added to your taxable income \$7,381.38 your 50 per cent community share of the distributive income of your husband, Dr. E. C. Moore, from the Moore-White Clinic, a partnership, for the period from January 1, 1939, to August 31, 1939, in accordance with the preliminary statement herein. Your reportable share is computed as follows:

Distributive income, Moore-White Clinic, for year 1939.....	\$26,323.35
Less: expenses	6,407.85
Net	<u>\$19,915.50</u>
Earned during period January 1 to August 31, 1939.....	\$14,762.76
Your 50 per cent community share.....	<u>\$ 7,381.38</u>

(b) Earned income credit is allowed as follows:

Your share of distribution from partnership for the period January 1, 1939, to August 31, 1939—earned income.....	\$ 7,381.38
Earned income credit (10 per cent of \$7,381.38).....	<u>\$ 738.14</u>

Computation of Tax

Year: 1939

Net income adjusted.....	\$63,364.66
Less: Personal exemption	\$2,500.00
Credit for dependent	400.00
	<u>2,900.00</u>
Balance (surtax net income).....	<u>\$60,464.66</u>
Less: Interest on U. S. obligations.....	\$ 107.49
(b) Earned income credit	738.14
	<u>845.63</u>
Net income subject to normal tax.....	<u>\$59,619.03</u>
Normal tax at 4 per cent on \$59,619.03.....	\$ 2,384.76
Surtax on \$60,464.66.....	<u>11,122.63</u>
Total tax	<u>\$13,507.39</u>
Less: Income tax paid at the source.....	6.47
Correct income tax liability.....	<u>\$13,500.92</u>
Income tax assessed: Original, account No. 203069—	
First California District	<u>10,756.30</u>
Deficiency of income tax.....	<u>\$ 2,744.62</u>

Adjustments of Net Income
Year: 1940

Net income as disclosed by return.....	\$11,714.27
Unallowable deductions and additional income:	
(a) Dividends	\$27,839.10
(b) Fiduciary income	30,404.37
(c) Other deductions	3.08
	<hr/>
Net income adjusted	\$69,960.82

Explanation of Adjustments

(a) Dividends in the amount of \$33,950.12 were received direct by you from the J. D. and A. B. Spreckels Company, of which only \$6,112.02 (\$6,111.02) or 18 per cent was reported on your return. The balance of \$27,839.10 is added to your taxable net income in accordance with the holding in the preliminary statement herein, that the distributions received by you in 1940 from this corporation were taxable as earnings dividends to the extent of 100 per cent.

(b) Your distributive share of taxable income from the following trusts is increased by \$30,404.37 as follows:

	As Revised	Reported	Increase
1. Claus Spreckels Trust	\$36,512.72	\$6,319.76	\$30,192.96
2. Ellis M. Spreckels Trust	276.20	64.79	211.41
	<hr/>	<hr/>	<hr/>
Totals	\$36,788.92	\$6,384.55	\$30,404.37

1. The income of the Claus Spreckels Trust is revised as follows:

Total distributive income as shown on the trust return.....\$51,174.98

Add: Portion of trustee's fees disallowed as

 applicable to exempt income..... 138.32

Revised distributive income

\$51,313.30

Your distributive share—23/32

\$36,881.08

Less: Your share of exempt interest on U. S.

 obligations, 23/32 of \$512.50..... 368.36

Your distributive share of taxable income as revised.....\$36,512.72

The trust return on Form 1041, reported dividends received from J. D. and A. B. Spreckels Company as 100 per cent taxable and also included the total dividends from this source as income to be distributed to the beneficiaries.

While the trust return reported your distributive share of trust income to be \$36,413.65, you reported only \$6,319.76 of such income on your individual return, and made the explanation that you considered the amount of dividends included therein from the J. D. and A. B. Spreckels Company as being 18 per cent taxable instead of 100 per cent taxable as reported by the trust. As set forth in the preliminary statement, it is held that such dividends are taxable to the extent of 100 per cent.

2. Income from the Ellis M. Spreckels Trust is revised as follows:	
Net distributive income as shown on the trust return.....	\$ 92.54
Add: Portion of trustee's fees disallowed as	
applicable to exempt income	302.04
Revised distributive income	\$394.58
Your distributive share, 70 per cent.....	\$276.20

(c) The deduction of \$70.58 investment expenses is reduced by an amount of \$3.08 held to be allocable to tax exempt income and non-deductible under section 24(a)(5) of the Internal Revenue Code.

Computation of Alternative Tax

Year: 1940

(Section 117 (c)—Internal Revenue Code)

Net income	\$69,960.82	
Minus: Net long term capital gain.....	1,883.07	
Ordinary net income	\$68,077.75	
Less: Personal exemption	\$2,000.00	
Credit for dependent	400.00	2,400.00
Balance (surtax net income).....	\$65,677.75	
Less: Interest on Government obligations, etc.....	\$ 212.11	
Earned income credit	300.00	512.11
Net income subject to normal tax.....	\$65,165.64	
Normal tax at 4 per cent on \$65,165.64.....	\$ 2,606.63	
Surtax on	\$65,677.75.....	18,848.54
Partial tax	\$21,455.17	
Plus: 30 per cent of net long-term gain.....	564.92	
Alternative tax	\$22,020.09	

Computation of Tax
Year: 1940

Net income adjusted		\$69,960.82
Less: Personal exemption	\$2,000.00	
Credit for dependent	400.00	2,400.00
Balance (surtax net income)		\$67,560.82
Less: Interest on U. S. obligations.....	\$ 212.11	
Earned income credit	300.00	512.11
Net income subject to normal tax.....		\$67,048.71
Normal tax at 4 per cent on \$67,048.71.....		\$ 2,681.95
Surtax on \$67,560.82.....		19,733.59
Total tax (ordinary rates)		\$22,415.54
Alternative tax		\$22,020.09
Add: 10 per cent defense tax.....		2,202.01
Total tax		\$24,222.10
Less: Income tax paid at the source.....		6.48
Correct income tax liability.....		\$24,215.62
Income tax assessed: Original, account No. 856204—		
First California District		716.46
Deficiency of income tax.....		\$23,499.16

Received and filed July 5, 1944, T.C.U.S.

[Title of Tax Court and Cause.]

Docket No. 5495.

ANSWER

Comes now the Commissioner of Internal Revenue, respondent above named, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition filed by the above-named petitioner, admits and denies as follows:

1. Admits the allegations contained in paragraph 1 of the petition.

2. Admits the allegations contained in paragraph 2 of the petition.

3. Admits that the taxes in controversy are income taxes for the calendar years 1937, 1938, 1939, and 1940; denies all other allegations contained in paragraph 3 of the petition.

4. (a) to (f), inclusive. Denies that the determination of tax set forth in the notice of deficiency is based upon errors as alleged in paragraph 4 and subparagraphs (a) to (f), inclusive, thereunder of the petition.

5. (a) Admits the allegations contained in subparagraph (a) of paragraph 5 of the petition.

(b) Denies the allegations contained in subparagraph (b) of paragraph 5 of the petition.

(c) Admits that the Commissioner has added to petitioner's income for the calendar year 1937 the sum of \$13,078.99 alleged to be petitioner's community share of her husband's partnership income, as alleged in subparagraph (c) of paragraph 5 of the petition; denies that such action was erroneous.

(d) Admits that the Commissioner has added to petitioner's income for the calendar year 1938 the sum of \$11,571.79 alleged to be petitioner's community share of her husband's partnership income, as alleged in subparagraph (d) of paragraph 5 of the petition; denies that such action was erroneous.

(e) Admits that the Commissioner has added to

petitioner's income for the calendar year 1939 the sum of \$7,381.38 alleged to be petitioner's community share of her husband's partnership income for the period January 1 to August 31, 1939, as alleged in subparagraph (e) of paragraph 5 of the petition; denies that such action was erroneous.

(f) Admits that during the calendar years 1937, 1938, 1939, and 1940 petitioner owned shares of capital stock of J. D. and A. B. Spreckels Company and trust certificates representing shares of capital stock of said corporation; admits that during the years 1937, 1938, 1939, and 1940 petitioner was the beneficiary of a trust known as the Claus Spreckels Trust, Crocker First National Bank of San Francisco, Trustee, and as such beneficiary was entitled to receive income from said trust during said years; admits that included in the assets of said trust during each of said years were trust certificates representing shares of the capital stock of J. D. and A. B. Spreckels Company; for lack of information and belief denies all remaining allegations contained in subparagraph (f) of paragraph 5 of the petition.

(g) Admits that during the calendar year 1937 J. D. and A. B. Spreckels Company made distributions to its stockholders; admits that with respect to petitioner's ownership of shares of stock and trust certificates she reported the receipt of certain of said distributions on her income tax return (Form 1040) for the calendar year 1937, which return was filed on March 15, 1938; for lack of information and belief denies all other allegations

contained in subparagraph (g) of paragraph 5 of the petition.

(h) Admits that on March 14, 1941, petitioner filed a claim for refund (Form 843) of income taxes for the calendar year 1937 in the amount of \$20,-546.60 and that the Commissioner has failed to allow any portion of said claim for refund; for lack of information and belief denies all other allegations contained in subparagraph (h) of paragraph 5 of the petition.

(i) Admits that during 1938 J. D. and A. B. Spreckels Company made distributions to its stockholders; admits that with respect to petitioner's ownership of shares of stock and trust certificates she reported the receipt of certain of said distributions on her income tax return (Form 1040) for the calendar year 1938, which return was filed on March 15, 1939; for lack of information and belief denies all other allegations contained in subparagraph (i) of paragraph 5 of the petition.

(j) Admits that on February 28, 1942, petitioner filed a claim for refund (Form 843) of income taxes for the calendar year 1938 in the amount of \$5,-723.26 and that the Commissioner has failed to allow any portion of said claim for refund; for lack of information and belief denies all other allegations contained in subparagraph (j) of paragraph 5 of the petition.

(k) Admits that during the calendar year 1939 J. D. and A. B. Spreckels Company made distributions to its stockholders; admits that with respect to petitioner's ownership of shares of stock and

trust certificates she reported the receipt of certain of said distributions on her income tax return (Form 1040) for the calendar year 1939; for lack of information and belief denies all other allegations contained in subparagraph (k) of paragraph 5 of the petition.

(l) Admits that on March 11, 1943, petitioner filed a claim for refund (Form 843) of income taxes for the calendar year 1939 in the amount of \$7,-324.66 and that the Commissioner has failed to allow any portion of said claim for refund; for lack of information and belief denies all other allegations contained in subparagraph (l) of paragraph 5 of the petition.

(m) Admits that during the calendar year 1940 J. D. and A. B. Spreckels Company made distributions to its stockholders and that petitioner excluded portions of said distributions from her income tax return (Form 1040) for the calendar year 1940; admits that petitioner received during the calendar year 1940 from said Claus Spreckels Trust distributions which had been received by said trust from said J. D. and A. B. Spreckels Company; admits that portions of said distribution were excluded by the petitioner from her income tax return for said year; for lack of information and belief denies all other allegations contained in subparagraph (m) of paragraph 5 of the petition.

(n) Admits that the Commissioner has increased petitioner's dividend income reported on line 2 of her 1940 return by the amount of \$27,839.10 and has increased petitioner's fiduciary income reported

on line 7 of her said return by the amount of \$30,-093.89 but denies that such actions were erroneous; for lack of information and belief denies all other allegations contained in subparagraph (n) of paragraph 5 of the petition.

(o), (p), (q), (r), and (s) denies all allegations contained in subparagraphs (o), (p), (q), (r), and (s) of paragraph 5 of the petition.

(t) and (u) for lack of information and belief denies all allegations contained in subparagraphs (t) and (u) of paragraph 5 of the petition.

6. Denies generally and specifically each and every allegation in the petition not hereinbefore admitted, qualified, or denied.

Wherefore, it is prayed that the Commissioner's determination be approved and the petitioner's appeal denied.

/s/ J. P. WENCHEL,

Chief Counsel, Bureau of
Internal Revenue.

Of Counsel:

B. H. NEBLETT,
Division Counsel.

T. M. MATHER,

ARTHUR L. MURRAY,
Special Attorneys,
Bureau of Internal Revenue.

Received and filed July 26, 1944 T.C.U.S.

[Title of Tax Court and Cause.]

Docket No. 5495

SUPPLEMENTARY STIPULATION
OF FACTS

It Is Hereby Stipulated and Agreed by and between the parties hereto, by their respective attorneys, that the following facts shall be taken as true upon the trial of the above-entitled case, provided, however, that this stipulation shall be without prejudice to the right of either party to introduce other and further evidence not inconsistent with the facts herein stipulated to be taken as true.

1. It is agreed that during the calendar years 1937 and 1938 respondent did not err in including in petitioner's income subject to tax for said years one-half of her husband's income from a professional partnership, of which he was a member, and in finding that for said years said income was community income and taxable to petitioner. The parties agree that for the period January 1 to August 31, 1939 respondent erred in including in petitioner's income subject to tax for said period one-half of her husband's income from said professional partnership, and it is agreed that no part of said income for said period is to be included in petitioner's taxable income.

2. It is agreed that during each of the calendar years 1937, 1938, 1939 and 1940 petitioner incurred expenses in the amount of \$1,200.00 and that of this amount \$600.00 per year is to be allowed petitioner

as a deduction for expenses incurred in the production or collection of income or for the management, conversion or maintenance of property held for the production of income.

3. Petitioner at all times during the calendar years 1938, 1939 and 1940 owned directly and in her own name 2 shares of the capital stock of J. D. and A. B. Speckels Company and voting trust certificates representing 498 shares of the capital stock of said company. Petitioner received from said company distributions on said shares in the following amounts:

Schedule A

Year	From Shares in Her Own Name	From Shares Covered by Voting Trust Certificate	Total
1/ 1/38 to 12/15/38.....	\$ 60.00	\$14,940.00	\$15,000.00
12/22/38	25.00	6,225.00	6,250.00
<hr/>			
Total 1938	\$ 85.00	\$21,165.00	\$21,250.00
1939	110.00	27,390.00	27,500.00
1940	136.00	33,864.00	34,000.00

At all times during the calendar years 1938, 1939 and 1940 petitioner was a beneficiary of a trust known as the Claus Spreckels Trust, Crocker First National Bank of San Francisco, Trustee, and as such beneficiary was entitled to receive 26/32 of the income of said trust for the period January 1 to and including September 26, 1938, and was entitled to receive 23/32 of the income of said trust for the period September 27 to December 31, 1938, and during the calendar years 1939 and 1940. Included in the assets of said trust during each of said years

were voting trust certificates representing 752 shares of the capital stock of J. D. and A. B. Spreckels Company. The distributions received by the trustee from said company were, under the terms of the trust, after deducting certain prior charges and expenses of the trust, currently distributable to the beneficiary. During said years the trustee made distributions as required by the terms of the trust and petitioner received from the trustee as petitioner's net share of said distributions of J. D. and A. B. Spreckels Company on said 752 shares the following amounts:

Schedule B			
Year	Net Distribution by Trustees	J. D. and A. B. Spreckels Company Dividends	Net Bal. of Other Items
1/ 1/38 to 12/15/38		\$17,801.25	
12/22/38 to 12/31/38		6,756.25	
1938 Total	\$24,435.17	\$24,557.50	(\$122.33)
1939	29,426.45	29,727.50	(\$301.05)
1940	36,881.44	36,754.00	\$127.44

The parties are agreed that the portions of the dividends of J. D. and A. B. Spreckels Company for the years 1938, 1939 and 1940 which this Court determines in the case of Grace H. Kelham, Petitioner vs. Commissioner of Internal Revenue, Respondent, Docket No. 5333, have been paid out of capital will represent: (a) The portions of the respective amounts listed in the "Total" column of Schedule A which are to be subtracted from the petitioner's taxable income for the respective years; and (b) the portions of the respective amounts listed in the column entitled "J. D. and A. B. Spreckels Com-

pany Dividends” of Schedule B which are to be subtracted from the respective amounts listed in the column entitled “Net Distributions by Trustee” of Schedule B in determining petitioner’s taxable income for the years 1938, 1939 and 1940.

Dated this 31st day of October, 1947.

/s/ LEON de FREMERY,
Attorney for Petitioner.

/s/ CHARLES OLIPHANT,
Chief Counsel, Bureau of
Internal Revenue.

Filed at hearing Nov. 3, 1947 T.C.U.S.

The Tax Court of the United States,
Washington

Docket No. 5495

ELLIS M. MOORE,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION

Pursuant to the Court’s Findings of Fact and Opinion, promulgated December 20, 1949, the respondent herein filed a computation of tax on February 28, 1950, and the petitioner on the same date

filed an acquiescence in the respondent's computation. In accordance therewith it is

Ordered and Decided: That for the year 1937 there is an over-payment in income tax of \$3,287.37, which amount was paid after the mailing of the notice of deficiency;

That for the year 1938 there is an over-payment in income tax of \$1,375.20, which amount was paid after the mailing of the notice of deficiency;

That for the year 1939 there is an over-payment of \$10,914.38, a portion of which amount was paid within three years before the filing of a claim for refund and the remainder was paid after the mailing of the notice of deficiency;

That for the year 1940 there is an over-payment in income tax of \$28,739.45, which amount was paid after the mailing of the notice of deficiency.

Enter:

[Seal] /s/ BOLON B. TURNER,
Judge.

Entered Mar. 14, 1950.

Served Mar. 15, 1950.

In the United States Court of Appeals
For the Ninth Circuit

T. C. Docket No. 5495

COMMISSIONER OF INTERNAL REVENUE,

Petitioner on Review,

vs.

ELLIS M. MOORE,

Respondent on Review.

PETITION FOR REVIEW

To the Honorable Judges of the United States
Court of Appeals for the Ninth Circuit:

The Commissioner of Internal Revenue hereby petitions the United States Court of Appeals for the Ninth Circuit to review the decision entered by the Tax Court of the United States on March 14, 1950, that there are overpayments of income tax for the years 1939 and 1940 in the respective amounts of \$10,914.38 and \$28,739.45 in respect of the Federal income tax liability of Ellis M. Moore, the above-named respondent on review. This petition for review is filed pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code.

The respondent on review, Ellis M. Moore, is a resident of California whose mailing address is 1110 Crocker Building, San Francisco, California. Respondent's Federal income tax returns for the calendar year 1939 and 1940, the taxable years here in-

volved, were filed with the Collector of Internal Revenue for the First District of California, whose office is located in San Francisco, California, and within the jurisdiction of the United States Court of Appeals for the Ninth Circuit where this review is sought.

Nature of Controversy

During the calendar years 1938, 1939 and 1940 the respondent on review was the owner of 2 shares of the capital stock of J. D. and A. B. Spreckels Company and voting trust certificates representing 498 shares of the capital stock of said company, in respect of which shares she received during the years 1938, 1939 and 1940 distributions in the respective amounts of \$21,250.00, \$27,500.00 and \$34,000. The respondent was also the beneficiary of a trust among the assets of which trust were voting trust certificates representing 752 shares of the capital stock of J. D. and A. B. Spreckels Company. As a part of her share of the distributable income of said trust for the years 1938, 1939 and 1940, the respondent received from the trustees, as her net share of distributions made to the trust by the J. D. and A. B. Spreckels Company in 1938, 1939 and 1940 on said 752 shares, the respective sums of \$24,557.50, \$29,727.50 and \$36,754.00. In her Federal income tax returns for the years 1939 and 1940 the respondent returned taxable income the amounts so received in 1939 but only \$6,112.02 in 1940 in respect of the shares and voting trust certificates of J. D. and A. B. Spreckels Company owned directly

by her and only \$6,319.76 in respect of her share of distributions made to the trust. The distributions received by the respondent in 1938 were reported as taxable income in her 1938 income tax return and there is now no dispute in respect thereof. In his determination of the respondent's tax liability for the year 1940 the Commissioner increased the distributions returned by the respondent to their full amounts.

It was the taxpayer's contention before the Tax Court of the United States, among other things, that in determining the percentages or amounts of the distributions made by the J. D. and A. B. Spreckels Company which represented taxable dividends in the hands of the recipients thereof it is necessary to first restore out of subsequent earnings and profits the pre-March 1, 1913, accumulated operating losses, or deficit, of the predecessor of J. D. and A. B. Spreckels Company and its affiliated companies. The Commissioner contended, on the other hand, that operating deficits as of March 1, 1913, may not be restored by subsequent earnings and profits in determining the amount of earnings or profits accumulated after February 28, 1913, which would constitute taxable dividends to the recipients in whole or in part. The Tax Court of the United States disagreed with the Commissioner's determination and allowed the restoration of pre-March 1, 1913, accumulated operating losses for the purpose of determining the amount of subsequent earnings and profits available for distribution as taxable dividends, as a result of which allowances the over-

payments of tax for the years 1939 and 1940 partly resulted.

/s/ THERON L. CAUDLE,
Assistant Attorney General.

/s/ CHARLES OLIPHANT,
Chief Counsel, Bureau of Internal Revenue, Attorneys for Petitioner on Review.

Received and filed June 2, 1950, T.C.U.S.

The Tax Court of the United States

Docket No. 5559

HARRIET H. BELCHER,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (LA:IT:90D:PB) dated April 22, 1944, and as a basis of her proceeding alleges as follows:

1. Petitioner is an individual, whose mailing address is c/o The First National Trust and Savings Bank, San Diego, California. The return for the period here involved was filed with the Collector of

Internal Revenue for the Sixth District of California.

2. The notice of deficiency (a copy of which is attached hereto and marked "Exhibit A") was mailed to petitioner on April 22, 1944.

3. The taxes in controversy are income taxes for the calendar year 1940 and in the amount of \$1,471.00.

4. The determination of tax set forth in said notice of deficiency is based on the following error:

(a) The Commissioner erred in determining that distributions made by J. D. and A. B. Spreckels Company to its stockholders during the calendar year 1940 were paid out of earnings or profits to the extent of 100% thereof and as a result of said determination increasing petitioner's income by the amount of \$31,950.48; and the Commissioner erred in failing to find that at least 79.792% of said distributions were not paid out of earnings or profits.

5. The facts upon which petitioner relies as the basis of this proceeding are as follows:

(a) During the calendar year 1940 petitioner was a beneficiary of a trust known as the Lillie S. Wegeforth Trust, Trust No. 1173, Crocker First National Bank of San Francisco, Trustee, and as such beneficiary was entitled to receive one-half of the income of said trust for the calendar year 1940. Included in the assets of said trust during the period January 1 to and including October 9, 1940, were voting trust certificates representing 1146

shares of the capital stock of J. D. and A. B. Spreckels Company. Included in the assets of said trust during the period October 10 to and including December 31, 1940, were voting trust certificates representing 1237 shares of the capital stock of J. D. and A. B. Spreckels Company.

(b) During the calendar year 1940 J. D. and A. B. Spreckels Company made distributions to its stockholders in the amount of \$68.00 a share, of which \$22.50 a share was paid during the period January 1 to October 9, 1940, and \$42.50 a share was paid during the period October 10 to December 31, 1940.

(c) Said Trust No. 1173, Crocker First National Bank of San Francisco, Trustee, received from said distributions the sum of \$82,068.50 less voting trustees' expenses in the sum of \$114.79, or \$81,953.71, and on its fiduciary return for the calendar year 1940 reported said sum in full as taxable income. Said return showed income distributable to petitioner in the amount of \$42,124.27, which amount included petitioner's one-half interest in said distributions in the amount of \$81,953.71, or the sum of \$40,976.85.

(d) Petitioner reported on line 7 of her income tax return (Form 1040) for the calendar year 1940, as income received from fiduciaries, the sum of \$13,789.84, of which amount the sum of \$10,173.79 was reported as having been received from said Trust No. 1173, Crocker First National Bank of San Francisco, Trustee.

(e) The difference between said sum of \$42,-

124.27 reported on said fiduciary return as taxable income distributable to petitioner and said sum of \$10,173.79 reported by petitioner as having been received from said fiduciary, namely, \$31,950.48, represents that part of petitioner's one-half portion of the dividends received by said fiduciary from J. D. and A. B. Spreckels Company during the calendar year 1940, which petitioner eliminated from taxable income as not having been paid out of the earnings or profits of said corporation. The Commissioner has erroneously increased petitioner's fiduciary income received from Trust No. 1173, Crocker First National Bank of San Francisco, Trustee, by said amount of \$31,950.48.

(f) Petitioner alleges that only a portion of said cash distributions in the amount of \$40,976.85 received by petitioner during the calendar year 1940 from J. D. and A. B. Spreckels Company through the medium of said Trust No. 1173, Crocker First National Bank of San Francisco, Trustee, to wit: the sum of not more than \$8,280.60, was paid out of the earnings or profits of said corporation accumulated after February 28, 1913, or out of its earnings or profits for the calendar year 1940, and that the balance of said sum of \$40,976.85, to wit: an amount not less than the sum of \$32,696.25, was not paid out of the earnings or profits of said corporation accumulated after February 28, 1913, nor out of its earnings or profits for the taxable year 1940, and that said balance was not subject to income tax in the hands of and was not taxable to petitioner.

(g) Petitioner is informed and believes and therefore alleges that on January 1, 1940, J. D. and A. B. Spreckels Company had no earnings or profits accumulated since March 1, 1913, and that its earnings or profits for the calendar year 1940 did not exceed \$274,827.56. During the calendar year 1940 J. D. and A. B. Spreckels Company made distributions to its stockholders in the amount of \$1,360,000.00.

(h) The basis to said Lillie S. Wegeforth Trust, No. 1173, Crocker First National Bank of San Francisco, Trustee, on January 1, 1940, for income tax purposes, of each share of the capital stock of J. D. and A. B. Spreckels Company represented by voting trust certificates held by said trust during the calendar year 1940 was greater than the aggregate cash distributions made by said corporation during said calendar year 1940 on each share of said stock.

Wherefore, petitioner prays that this Court may hear this proceeding and determine that there is no deficiency in income tax due from petitioner for the calendar year 1940.

/s/ LEON de FREMERY,
Counsel for Petitioner.

State of California,
County of San Diego—ss.

Harriet H. Belcher, being duly sworn, says that she is the petitioner above named; that she has read the foregoing petition, or had the same read to her, and is familiar with the statements contained

therein, that the statements contained therein are true, except those stated to be upon information and belief, and those she believes to be true.

/s/ HARRIET H. BELCHER.

Subscribed and sworn to before me this 7th day of July, 1944.

[Seal] /s/ R. N. CHAMBERLIN,
Notary Public.

My Commission Expires Nov. 25, 1945.

EXHIBIT A

Treasury Department
Internal Revenue Service
417 South Hill Street,
Los Angeles 13, California

Office of
Internal Revenue Agent in Charge
Los Angeles Division
LA:IT:90D:PB

Apr. 22, 1944.

Mrs. Harriet H. Belcher
c/o First National Trust and Savings Bank
San Diego, California

Dear Mrs. Belcher:

You are advised that the determination of your income tax liability for the taxable year ended December 31, 1940 discloses a deficiency of \$1,471.00, as shown in the statement attached.

In accordance with the provisions of existing

internal revenue laws, notice is hereby given of the deficiency or deficiencies mentioned.

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with The Tax Court of the United States, at its principal address, Washington, D. C., for a redetermination of the deficiency or deficiencies.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Internal Revenue Agent in Charge, Los Angeles, California, for the attention of LA:Conf. The signing and filing of this form will expedite the closing of your return by permitting an early assessment of the deficiency or deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Very truly yours,

JOSEPH D. NUNAN, JR.,

Commissioner,

By /s/ GEORGE D. MARTIN,

Internal Revenue Agent in
Charge.

Enclosures:

Statement

Form of waiver

Statement

LA:IT:90D:PB

Mrs. Harriet H. Belcher,
c/o First National Trust and Savings Bank
San Diego, California

Tax Liability for the Taxable Year Ended December 31, 1940

	Liability	Assessed	Deficiency
Income Tax	\$1,471.00	None	\$1,471.00

In making this determination of your income tax liability, careful consideration has been given to the report of examination dated May 10, 1943, to your protest dated June 25, 1943, and to the statements made at the conferences held on February 15 and February 23, 1944.

A copy of this letter and statement has been mailed to your representative, Mr. Leon de Fremery, 1110 Crocker Building, San Francisco, California, in accordance with the authority contained in the power of attorney executed by you.

Adjustments to Net Income

Net income (loss) as disclosed by return.....	(\$17,956.59)
Additional income:	
(a) Income from trust	32,435.80
Total	\$14,479.21
Additional deduction:	
(b) Contributions	546.30
Net income adjusted	\$13,932.91

Explanation of Adjustments

(a) Income of Trust No. 1173, Crocker First National Bank of San Francisco, Trustee, taxable to you has been increased as follows:

1. Dividends received	\$31,950.48
2. Trustee's fees disallowed	485.32
Total.....	\$32,435.80

1. You are the beneficial owner of shares of stock of J. D. and A. B. Spreckels Company. You contend that your distributive share of the distributions by said corporation in the year 1940 is taxable as dividends to the extent of only 18 per cent. It is held that the distributions are out of earnings and profits accumulated after February 28, 1913, and are taxable as dividends in their entirety.

2. This amount of trustee's fees is disallowed as being allocable to exempt income. Section 24(a)(5) of the Internal Revenue Code.

(b) In view of the above addition to income the contributions listed in your return in the amount of \$546.30, not claimed as a deduction, are allowed as a deduction.

Computation of Tax

Net income adjusted	\$13,932.91
Less: Personal exemption (claimed by husband).....	None
Balance (surtax net income).....	\$13,932.91
Less: Earned income credit	300.00
Net income subject to normal tax.....	\$13,632.91
Normal tax at 4% on \$13,632.91.....	\$545.32
Surtax on \$13,932.91.....	791.95
Total normal tax and surtax.....	\$ 1,337.27
Defense tax (10% of \$1,337.27).....	133.73
Total income tax	\$ 1,471.00
Correct income tax liability.....	\$ 1,471.00
Income tax assessed: Original, account No. 728078.....	None
Deficiency of income tax.....	\$ 1,471.00

Received and filed July 17, 1944, T.C.U.S.

[Title of Tax Court and Cause.]

Docket No. 5559.

ANSWER

Comes now the Commissioner of Internal Revenue, respondent above named, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition filed by the above-named petitioner, admits and denies as follows:

1. Admits the allegations contained in paragraph 1 of the petition.

2. Admits the allegations contained in paragraph 2 of the petition.

3. Admits the allegations contained in paragraph 3 of the petition.

4. Denies that the determination of tax set forth in the notice of deficiency is based upon error as alleged in paragraph 4 and subparagraph (a) thereof of the petition.

5. (a) Admits that during the calendar year 1940 petitioner was a beneficiary of a trust known as the Lillie S. Wegeforth Trust, Trust No. 1173, Crocker First National Bank of San Francisco, Trustee, and as such beneficiary was entitled to receive income of said trust for the calendar year 1940; admits that included in the assets of said trust during the period January 1 to and including October 9, 1940, were voting trust certificates representing shares of the capital stock of J. D. and A. B. Spreckels Company, and that included in the assets of said trust during the period October 10 to and including December 31, 1940, were voting trust certificates representing shares of the capital stock of J. D. and A. B. Spreckels Company; for lack of information and belief denies all other allegations contained in subparagraph (a) of paragraph 5 of the petition.

(b) Admits that during the calendar year 1940 J. D. and A. B. Spreckels Company made distributions to its shareholders; for lack of information and belief denies all other allegations contained in subparagraph (b) of paragraph 5 of the petition.

(c) Admits that said Trust No. 1173, Crocker First National Bank of San Francisco, Trustee, re-

ceived certain of said distributions; for lack of information and belief denies all other allegations contained in subparagraph (c) of paragraph 5 of the petition.

(d) Admits that petitioner reported on line 7 of her income tax return (Form 1040) for the calendar year 1940, as income received from fiduciaries, the sum of \$13,789.84; for lack of information and belief denies all other allegations contained in subparagraph (d) of paragraph 5 of the petition.

(e), (f), (g), and (h). Denies the allegations contained in subparagraphs (e), (f), (g), and (h) of paragraph 5 of the petition.

6. Denies generally and specifically each and every allegation in the petition not hereinbefore admitted, qualified, or denied.

Wherefore, it is prayed that the Commissioner's determination be approved and the petitioner's appeal denied.

/s/ J. P. WENCHEL,
Chief Counsel, Bureau of
Internal Revenue.

Of Counsel:

B. H. NEBLETT,
Division Counsel.

T. M. MATHER,

ARTHUR L. MURRAY,
Special Attorneys,
Bureau of Internal Revenue.

Received and filed Sept. 4, 1944, T.C.U.S.

[Title of Tax Court and Cause.]

Docket No. 5559.

SUPPLEMENTARY STIPULATION
OF FACTS

It Is Hereby Stipulated and Agreed by and between the parties hereto, by their respective attorneys, that the following facts shall be taken as true upon the trial of the above-entitled case, provided, however, that this stipulation shall be without prejudice to the right of either party to introduce other and further evidence not inconsistent with the facts herein stipulated to be taken as true.

Petitioner at all times during the calendar year 1940 was a beneficiary of a trust known as the Lillie S. Wegeforth Trust, Trust No. 1173, Crocker First National Bank of San Francisco, Trustee, and as such beneficiary was entitled to receive one-half of the income of said trust for the calendar year 1940. Included in the assets of said trust during the period January 1 to and including October 9, 1940, were voting trust certificates representing 1,146 shares of the capital stock of J. D. and A. B. Spreckels Company. Included in the assets of said trust during the period October 10 to and including December 31, 1940, were voting trust certificates representing 1,237 shares of the capital stock of J. D. and A. B. Spreckels Company. Distributions received by the trustee from said company were, under the terms of the trust, after deducting certain prior charges and expenses of the trust, cur-

rently distributable to the beneficiaries. During the year 1940 petitioner received indirectly through said trust dividends from J. D. and A. B. Spreckels Company in the amount of \$41,034.25.

The parties are agreed that the portion of the dividends of J. D. and A. B. Spreckels Company for the year 1940 which this Court determines in the case of Grace H. Kelham, Petitioner, vs. Commissioner of Internal Revenue, Respondent, Docket No. 5333, has been paid out of capital will represent the portion of the amount of \$41,034.25 which is to be subtracted from said amount in determining petitioner's taxable income for the year 1940.

Dated this 31st day of October, 1947.

/s/ LEON de FREMERY,
Attorney for Petitioner.

/s/ CHARLES OLIPHANT,
Chief Counsel, Bureau of
Internal Revenue.

Filed at hearing Nov. 3, 1947, T. C. U. S.

The Tax Court of the United States, Washington
Docket No. 5559

HARRIET H. BELCHER,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION

Pursuant to the Court's Findings of Fact and Opinion, promulgated December 20, 1949, the respondent herein filed a computation of tax on February 28, 1950, and the petitioner on the same date filed an acquiescence in the respondent's computation. In accordance therewith it is

Ordered and Decided: That there is no deficiency in income tax for the year 1940.

Enter:

[Seal] /s/ BOLON B. TURNER,
Judge.

Entered Mar. 14, 1950.

Served Mar. 15, 1950.

In the United States Court of Appeals
for the Ninth Circuit
T. C. Docket No. 5559

COMMISSIONER OF INTERNAL REVENUE,
Petitioner on Review,

vs.

HARRIET H. BELCHER,
Respondent on Review.

PETITION FOR REVIEW

To the Honorable Judges of the United States Court
of Appeals for the Ninth Circuit:

The Commissioner of Internal Revenue hereby petitions the United States Court of Appeals for the Ninth Circuit to review the decision entered by The Tax Court of the United States on March 14, 1950, "That there is no deficiency in income tax for the year 1940" in respect of the Federal income tax liability of Harriet H. Belcher, the above-named respondent on review. This petition for review is filed pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code.

The respondent on review, Harriet H. Belcher, is a resident of California whose mailing address is c/o The First National Trust and Savings Bank, San Diego, California. Respondent's Federal income tax return for the calendar year 1940, the taxable year here involved, was filed with the Col-

lector of Internal Revenue for the Sixth District of California, whose office is located in Los Angeles, California, and within the jurisdiction of the United States Court of Appeals for the Ninth Circuit where this review is sought.

Nature of Controversy

During the taxable year 1940 the respondent on review was the beneficiary of a trust among the assets of which trust were voting trust certificates representing 1,146 shares of the capital stock of J. D. and A. B. Spreckels Company during the period January 1 to and including October 9, 1940, and voting trust certificates representing 1,237 shares of the capital stock of said company during the period October 10, 1940, to and including December 31, 1940. As a part of her share of the distributable income of said trust for the year 1940, the respondent received from the trustees, as her net share of distributions made to the trust by the J. D. and A. B. Spreckels Company in 1940 on said shares, the sum of \$41,034.25. In her Federal income tax return for the year 1940 the respondent returned as taxable income only \$10,173.79 of the distributable income of the trust, which amount included or reflected only approximately 18 per cent of her share of distributions made to the trust by the J. D. and A. B. Spreckels Company. In his redetermination of the respondent's tax liability for the year 1940 the Commissioner increased the distributions returned by the respondent to their full amounts.

It was the taxpayer's contention before The Tax Court of the United States, among other things, that in determining the percentages or amounts of the distributions made by the J. D. and A. B. Spreckels Company which represented taxable dividends in the hands of the recipients thereof it is necessary to first restore out of subsequent earnings and profits the pre-March 1, 1913, accumulated operating losses, or deficit, of the predecessor of J. D. and A. B. Spreckels Company and its affiliated companies. The Commissioner contended, on the other hand, that operating deficits as of March 1, 1913, may not be restored by subsequent earnings and profits in determining the amount of earnings or profits accumulated after February 28, 1913, which would constitute taxable dividends to the recipients in whole or in part. The Tax Court of the United States disagreed with the Commissioner's determination and allowed the restoration of pre-March 1, 1913, accumulated operating losses for the purpose of determining the amount of subsequent earnings and profits available for distribution as taxable dividends.

/s/ THERON L. CAUDLE,

Assistant Attorney General.

/s/ CHARLES OLIPHANT,

Chief Counsel, Bureau of Internal Revenue, Attorneys for Petitioner on Review.

Received and filed June 2, 1950, T.C.U.S.

The Tax Court of the United States
Docket No. 5560

LILLIE S. WEDGEFORTH,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (LA:IT:90D:PB) dated May 13, 1944, and as a basis of her proceeding alleges as follows:

1. Petitioner is an individual, whose mailing address is c/o The First National Trust and Savings Bank of San Diego, San Diego, California. The returns for the periods here involved were filed with the Collector for the Sixth District of California.

2. The notice of deficiency (a copy of which is attached hereto and marked "Exhibit A") was mailed to petitioner on May 13, 1944.

3. The taxes in controversy are income taxes for the calendar years 1938, 1939 and 1940, and in the following amounts:

Year	Deficiency Asserted	Overpayment Claimed	Amount in Controversy
1938.....	\$ 711.19	\$15,578.82	\$16,290.01
1939.....	1,069.75	32,427.63	33,497.38
1940.....	80,032.58	.....	79,238.56

4. The determination of tax set forth in said notice of deficiency is based upon the following errors:

(a) The Commissioner erred in determining that distributions made by J. D. and A. B. Spreckels Company to its stockholders during the calendar year 1938 were paid out of earnings or profits to the extent of 100% thereof; and the Commissioner erred in failing to find that no portion of said distributions were paid out of earnings or profits, and in failing to allow in full petitioner's claim for refund of income taxes paid for the calendar year 1938.

(b) The Commissioner erred in determining that distributions made by J. D. and A. B. Spreckels Company to its stockholders during the calendar year 1939 were paid out of earnings or profits to the extent of 100% thereof; and the Commissioner erred in failing to find that at least 45.186% of said distributions were not paid out of earnings or profits, and in failing to allow to that extent petitioner's claim for refund of income taxes paid for the calendar year 1939.

(c) The Commissioner erred in determining that distributions made by J. D. and A. B. Spreckels Company to its stockholders during the calendar year 1940 were paid out of earnings or profits to the extent of 100% thereof and as a result of said determination increasing petitioner's income for the year 1940 by the amount of \$153,953.36; and the Commissioner erred in failing to find that at least

79.792% of said distributions were not paid out of earnings or profits.

5. The facts upon which petitioner relies as the basis of this proceeding are as follows:

(a) During the calendar years 1938, 1939 and 1940 petitioner was the beneficiary of a trust known as the Lillie S. Wegeforth Trust, Trust No. 5380, The First National Trust and Savings Bank of San Diego, Trustee, and as such beneficiary was entitled to receive the entire income of said trust during each of said years. Included in the assets of said trust during each of said years were 2 shares of the capital stock of J. D. and A. B. Spreckels Company and voting trust certificates representing 2,186 shares of the capital stock of said corporation.

(b) During the calendar years 1938, 1939 and 1940 petitioner was a beneficiary of a trust known as the Lillie S. Wegeforth Trust, Trust No. 1173, Crocker First National Bank of San Francisco, Trustee, and as such beneficiary was entitled to receive one-half of the income of said trust during each of said years. Included in the assets of said trust during the calendar years 1938 and 1939 and the period January 1 to and including October 9, 1940, were voting trust certificates representing 1,146 shares of the capital stock of J. D. and A. B. Spreckels Company. Included in the assets of said trust during the period October 10 to December 31, 1940, were voting trust certificates representing 1,237 shares of the capital stock of J. D. and A. B. Spreckels Company.

(c) During the calendar year 1938, J. D. and A. B. Spreckels Company made distributions to its stockholders in the amount of \$42.50 a share. Said trust, No. 5380, The First National Trust and Savings Bank of San Diego, Trustee, received from said distributions the sum of \$92,990.00. Due to certain deductions taken by said trust on its income tax return for said year the distributable income reported by petitioner on line 7 of her income tax return (Form 1040) for the calendar year 1938 was the sum of \$79,761.47. Petitioner also reported on line 7 of her said return, as income received from said trust, No. 1173, Crocker First National Bank of San Francisco, Trustee, the sum of \$25,004.94, which sum included dividends received from J. D. and A. B. Spreckels Company in the sum of \$24,352.50. Petitioner filed said income tax return for the calendar year 1938 on March 15, 1939.

(d) On February 27, 1942, petitioner filed a claim for refund (Form 843) of income taxes paid for the calendar year 1938 in the amount of \$15,578.82. Said claim for refund was based on the ground that no portion of said cash distributions made by J. D. and A. B. Spreckels Company during the calendar year 1938 was paid out of the earnings or profits of J. D. and A. B. Spreckels Company and that said distributions received by petitioner through the medium of said trust, No. 5380, The First National Trust and Savings Bank of San Diego, Trustee, and said trust, No. 1173, Crocker First National Bank of San Francisco, Trustee, were not subject to income tax. The Commissioner

has failed to allow any portion of said claim for refund.

(e) During the calendar year 1939, J. D. and A. B. Spreckels Company made distributions to its stockholders in the amount of \$55.00 a share. Petitioner reported the receipt of said distributions on line 7 of her income tax return (Form 1040) for the calendar year 1939 as follows: As income received from said trust No. 5380, The First National Trust and Savings Bank of San Diego, Trustee (included in the sum of \$126,481.85) the amount of \$120,340.00 representing dividends on 2,188 shares; and as income received from said trust No. 1173, Crocker First National Bank of San Francisco, Trustee (included in the sum of \$32,358.33) the amount of \$31,515.00 representing dividends on 723 shares. Petitioner filed said income tax return for the calendar year 1939 on March 15, 1940.

(f) On February 12, 1943, petitioner filed a claim for refund (Form 843) of income taxes paid for the calendar year 1939 in the amount of \$41,169.64. Said claim for refund was based on the ground that no portion of said cash distributions made by J. D. and A. B. Spreckels Company during the calendar year 1939 was paid out of the earnings or profits of J. D. and A. B. Spreckels Company and that said distributions received by petitioner through the medium of said trust No. 5380, The First National Trust and Savings Bank of San Diego, Trustee, and said Trust No. 1173,

Crocker First National Bank of San Francisco, Trustee, were not subject to income tax. The Commissioner has failed to allow any portion of said claim for refund.

(g) During the calendar year 1940, J. D. and A. B. Spreckels Company made distributions to its stockholders in the amount of \$68.00 a share, of which \$22.50 a share was paid during the period January 1 to October 9, 1940, and \$45.50 a share was paid during the period October 10 to December 31, 1940.

(h) Said trust No. 5380, The First National Trust and Savings Bank of San Diego, Trustee, received from said distributions the sum of \$148,784.00 and on its fiduciary return for the calendar year 1940 excluded 82% thereof or \$122,002.88 as non-taxable distributions. The balance of said distributions in the amount of \$26,781.12 was reported on said return as taxable income. After deducting the excess in the sum of \$1,727.37 of expenses over other income, said return showed income distributable to petitioner in the amount of \$25,053.75, which petitioner reported on line 7 of her income tax return (Form 1040) for the calendar year 1940.

(i) Said trust No. 1173, Crocker First National Bank of San Francisco, Trustee, received from said distributions the sum of \$82,068.50 less voting trustees' expenses in the sum of \$114.79, or \$81,953.71, and on its fiduciary return for the calendar year 1940 reported said sum in full as taxable income. Said return showed income distributable to petitioner in the amount of \$42,124.27, which

amount included petitioner's one-half interest in said distributions in the amount of \$81,953.71, or the sum of \$40,976.85. From said distributable income in the amount of \$42,124.27, petitioner excluded \$31,950.48 as constituting non-taxable distributions and reported the remainder of said sum of \$42,124.27, or \$10,173.79, on line 7 of her said income tax return for the calendar year 1940 as income received from said trust No. 1173.

(j) The Commissioner has erroneously increased petitioner's fiduciary income received from trust No. 5380, The First National Trust and Savings Bank of San Diego, Trustee, by the sum of \$122,002.88, and has erroneously increased petitioner's fiduciary income received from trust No. 1173, Crocker First National Bank of San Francisco, Trustee, by the amount of \$31,950.48. The total of said adjustments in the amount of \$153,953.36 represents that portion of the distributions received by said trust No. 5380 and said trust No. 1173 from J. D. and A. B. Spreckels Company during the calendar year 1940 which petitioner excluded from income on the ground that such distributions constituted non-taxable distributions as aforesaid.

(k) Petitioner alleges that no part of said cash distributions in the sum of \$92,990.00 received from J. D. and A. B. Spreckels Company by said trust No. 5380, The First National Trust and Savings Bank of San Diego, Trustee, during the calendar year 1938, and that no part of said cash distributions in the sum of \$48,705.00 received by said trust

No. 1173, Crocker First National Bank of San Francisco, Trustee, during the calendar year 1938, from J. D. and A. B. Spreckels Company, was paid out of the earnings or profits of said corporation accumulated after February 28, 1913, or out of earnings or profits for the calendar year 1938. Petitioner alleges further that the entire distributable income of said trust No. 5380 in the amount of \$79,761.47 reported by petitioner on her income tax return as aforesaid, and the sum of \$24,332.50 (included in the sum of \$25,004.94) reported by petitioner as income received from said trust No. 1173, were not subject to income tax in the hands of and were not taxable to petitioner.

(1) Petitioner alleges that only a portion of said cash distributions in the sum of \$151,855.00 received by petitioner during the calendar year 1939 from J. D. and A. B. Spreckels Company through the medium of said trust No. 5380, The First National Trust and Savings Bank of San Diego, Trustee, and trust No. 1173, Crocker First National Bank of San Francisco, Trustee, to wit: the sum of not more than \$83,237.80, was paid out of the earnings or profits of said corporation accumulated after February 28, 1913, or out of its earnings or profits for the calendar year 1939, and that the balance of said sum of \$151,855.00, to wit: an amount not less than the sum of \$68,617.20 was not paid out of the earnings or profits of said corporation accumulated after February 28, 1913, nor out of its earnings or profits for the calendar year 1939, and that said

balance was not subject to income tax in the hands of and was not taxable to petitioner.

(m) During the calendar year 1940 said trust No. 5380, The First National Trust and Savings Bank of San Diego, Trustee, received from J. D. and A. B. Spreckels Company distributions in the sum of \$148,784.00 as aforesaid and after deducting the excess in the sum of \$1,727.37 of expenses over other income, as aforesaid, distributed to petitioner the sum of \$147,056.63. During the calendar year 1940 petitioner received from J. D. and A. B. Spreckels Company through the medium of trust No. 1173, Crocker First National Bank of San Francisco, Trustee, distributions in the amount of \$40,976.85 as aforesaid. Petitioner alleges that only a portion of said total cash distributions in the sum of \$188,033.48 received by petitioner during the calendar year 1940 from J. D. and A. B. Spreckels Company through the medium of said trust No. 5380 and said trust No. 1173, to wit: the sum of not more than \$37,997.81, was paid out of the earnings or profits of said corporation accumulated after February 28, 1913, or out of its earnings or profits for the calendar year 1940, and that the balance of said sum of \$188,033.48, to wit: an amount not less than the sum of \$150,035.67, was not paid out of the earnings or profits of said corporation accumulated after February 28, 1913, nor out of its earnings or profits for the calendar year 1940, and that said balance was not subject to income tax in the hands of and was not taxable to petitioner.

(n) Petitioner is informed and believes and

therefore alleges that on January 1, 1938, J. D. and A. B. Spreckels Company had no earnings or profits accumulated since March 1, 1913, that its earnings or profits for the calendar years 1938, 1939 and 1940 did not exceed the amounts set forth below, and that the distributions to its stockholders made by said corporation during said years were as follows:

Year	Earnings or Profits	Distributions
1938.....	(Loss) \$1,313,516.91	\$ 850,000.00
1939.....	602,954.70	1,100,000.00
1940.....	274,827.56	1,360,000.00

(o) The basis to said trust No. 5380, The First National Trust and Savings Bank of San Diego, Trustee, and said trust No. 1173, Crocker First National Bank of San Francisco, Trustee, of each share of the capital stock of J. D. and A. B. Spreckels Company, and of each share of said stock represented by voting trust certificates, held by said trusts during the calendar years 1938, 1939 and 1940 was greater than the aggregate cash distributions made by said corporation during said three-year period on each of said shares.

Wherefore, petitioner prays that this Court may hear this proceeding and determine that petitioner is entitled to a refund of income taxes paid for the calendar year 1938 of at least \$15,578.82; that petitioner is entitled to a refund of income taxes paid for the calendar year 1939 of at least \$32,427.63; and that the deficiency in income tax for the calendar year 1940 does not exceed \$794.02.

/s/ LEON de FREMERY,

Counsel for Petitioner.

State of California,
County of San Diego—ss.

Lillie S. Wegeforth, being duly sworn, says that she is the petitioner above named; that she has read the foregoing petition, or had the same read to her, and is familiar with the statements contained therein, that the statements contained therein are true, except those stated to be upon information and belief, and those she believes to be true.

/s/ LILLIE S. WEGEFORTH.

Subscribed and sworn to before me this 10th day of July, 1944.

[Seal] /s/ R. N. CHAMBERLIN,
Notary Public.

My Commission Expires Nov. 25, 1945.

EXHIBIT A

Treasury Department
Internal Revenue Service
417 South Hill Street

Los Angeles 13, California

Office of
Internal Revenue Agent in Charge
Los Angeles Division
LA :IT :90D :PB

May 13, 1944

Mrs. Lillie S. Wegeforth

c/o The First National Trust and Savings Bank of
San Diego,
San Diego, California

Dear Mrs. Wegeforth:

You are advised that the determination of your income tax liability for the taxable years ended December 31, 1937, to 1940, inclusive, discloses a deficiency of \$81,813.52 for the taxable years ended December 31, 1938, 1939 and 1940, and an overassessment of \$600.01 for the taxable year ended December 31, 1937, as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency or deficiencies mentioned.

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with The Tax Court of the United

States, at its principal address, Washington, D. C., for a redetermination of the deficiency or deficiencies.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Internal Revenue Agent in Charge, Los Angeles, California, for the attention of LA:Conf. The signing and filing of this form will expedite the closing of your return(s) by permitting an early assessment of the deficiency or deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Very truly yours,

JOSEPH D. NUNAN, JR.,
Commissioner.

By /s/ RAYMON B. SULLIVAN,
Acting Internal Revenue
Agent in Charge.

PB:vmc

Enclosures:

Statement

Form of waiver.

Statement

LA:IT:90D:PB

Mrs. Lillie S. Wegeforth
c/o The First National Trust

and Savings Bank of San Diego
San Diego, California

Tax Liability for the Taxable Years Ended
December 31, 1938, 1939 and 1940

Income Tax

Year	Liability	Assessed	Overassessment	Deficiency
1937.....	\$ 68,460.20	\$ 69,060.21	\$600.01	
1938.....	16,290.01	15,578.82		\$ 711.19
1939.....	42,239.39	41,169.64		1,069.75
1940.....	80,993.39	960.81		80,032.58
Total	\$207,982.99	\$126,769.48	\$600.01	\$81,813.52

In making this determination of your income tax liability, careful consideration has been given to the reports of examination dated November 30, 1942, and May 10, 1943, to your claims for refund for the year 1937 filed on December 4, 1937, March 7, 1941, and February 27, 1942, to your claims for refund for 1938 and 1939 filed on February 27, 1942, and February 12, 1943, respectively, to your protests dated February 9 and June 25, 1943, and to the statements made at the conferences held.

You are the beneficial owner of shares of stock of J. D. and A. B. Spreckels Company. You contend that your distributive share of the distributions by said corporation in the year 1938 is not taxable and that your distributive share in the years 1939 and 1940 is taxable in part only. In the years 1937, 1938 and 1939 you reported the distributions as taxable income. In the year 1940, you reported only 18 per cent as taxable. It is held that the distributions are out of earnings and profits accumulated after February 28, 1913, and are taxable as dividends in their entirety.

You are the beneficiary of trusts which derive taxable income and tax exempt income. Expenses allocable to tax exempt income are found to be as follows:

	1937	1938	1939	1940
Trust #5380, First National Trust and Savings Bank of San Diego	\$ 485.07	\$ 592.78	\$ 657.31	\$ 779.87
Trust #P1173, Crocker First National Bank, San Fran- cisco	488.27	625.38	568.07	485.33
Trust #2356, Crocker First National Bank, San Fran- cisco	134.14	0	0	0
Total.....	\$1,107.48	\$1,218.16	\$1,225.38	\$1,265.20

The above-mentioned amounts are not deductible in computing trust income taxable to you. Section 24(a)(5) of the Revenue Acts of 1936 and 1938 and of the Internal Revenue Code.

If a petition to The Tax Court of the United States is filed against the deficiency proposed herein, the issue set forth in your claims for refund for the years 1938 and 1939 should be made a part of the petition to be considered by the Court in any redetermination of your tax liability. If a petition is not filed, the claims for refund will be disallowed and official notice will be issued by registered mail in accordance with section 3772 of the Internal Revenue Code.

The overassessment shown herein will be made the subject of a certificate of overassessment which will reach you in due course through the office of the collector of internal revenue for your district, and will be applied by that official in accordance with section 322(a) of the Revenue Act of 1936.

A copy of this letter and statement has been mailed to your representative, Mr. Leon F. de Fremery, 1110 Crocker Building, San Francisco, California, in accordance with the authority contained in the power of attorney executed by you.

Adjustments to Net Income

Taxable Year Ended December 31, 1937

Net income as disclosed by return.....	\$156,663.90
Additional income and unallowable deductions:	
(a) Trust income increased	\$1,107.48
(b) Partnership loss decreased	1,867.24 2,974.72
Total	\$159,638.62
Reduction in income:	
(c) Mathematical error	3,165.12
Net income adjusted	\$156,473.50

Explanation of Adjustments

- (a) This adjustment has been previously explained.
- (b) Your distributive share of loss of the partnership Belbrook Stables has been determined to be \$19,644.86, in lieu of \$21,512.10 claimed.
- (c) Due to a mathematical error made in your return the \$2,592.09 capital gain reported is adjusted to a capital loss of \$573.03.

Computation of Tax
Taxable Year Ended December 31, 1937

Net income adjusted		\$156,473.50
Less: Personal exemption.....		1,000.00
Balance (surtax net income).....		<u>\$155,473.50</u>
Less: Interest on U. S. obligations	\$ 269.83	
Earned income credit	300.00	569.83
Net income subject to normal tax.....		<u>\$154,903.67</u>
Normal tax at 4% on \$154,903.67.....	\$ 6,196.15	
Surtax on \$155,473.50.....	62,284.10	
Total income tax		<u>\$ 68,480.25</u>
Less: Income tax paid at source.....		20.05
Correct income tax liability.....		<u>\$ 68,460.20</u>
Income tax assessed:		
Original, account No. 204202.....	\$68,582.05	
Deficiency, February, 1941, List,		
account No. 510211.....	478.16	
Total income tax assessed.....		<u>69,060.21</u>
Overassessment of income tax.....		<u>\$ 600.01</u>

Adjustments to Net Income
Taxable Year Ended December 31, 1938

Net income as disclosed by return.....		\$64,703.76
Additional income and unallowable deductions:		
(a) Trust income increased	\$1,218.16	
(b) Contributions disallowed	295.00	1,513.16
Net income adjusted		<u>\$66,216.92</u>

Explanation of Adjustments

- (a) This adjustment has been previously explained.
- (b) The deduction of \$295.00 claimed as contribution to Coronado Horse Show is not allowable under the provisions of section 23(o) or 23(a) of the Revenue Act of 1938.

Computation of Alternative Tax
Taxable Year Ended December 31, 1938

Net income adjusted	\$66,216.92
Plus: Net long-term capital loss	5,235.61
Ordinary net income	\$71,452.53
Less: Personal exemption	1,000.00
Balance (surtax net income).....	\$70,452.53
Less: Earned income credit	300.00
Net income subject to normal tax.....	\$70,152.53
Normal tax at 4% on \$70,152.53.....	\$ 2,806.10
Surtax on \$70,452.53.....	15,054.59
Partial tax	\$17,860.69
Minus: 30% of net long-term capital loss.....	1,570.68
Alternative tax	\$16,290.01

Computation of Tax
Taxable Year Ended December 31, 1938

Net income adjusted	\$66,216.92
Less: Personal exemption.....	1,000.00
Balance (surtax net income).....	\$65,216.92
Less: Earned income credit	300.00
Net income subject to normal tax.....	\$64,916.92
Normal tax at 4% on \$64,916.92.....	\$ 2,596.68
Surtax on \$65,216.92.....	12,914.60
Total	\$15,511.28
Alternative tax	\$16,290.01
Correct income tax liability.....	\$16,290.01
Income tax assessed: Original, account No. 841692.....	15,578.82
Deficiency of income tax.....	\$ 711.19

Adjustments to Net Income
Taxable Year Ended December 31, 1939

Net income as disclosed by return.....	\$109,978.97
Additional income and unallowable deductions:	
(a) Trust income increased	\$1,225.38
(b) Contributions disallowed	500.00
Net income adjusted	\$111,704.35

Explanation of Adjustments

(a) This adjustment has been previously explained.

(b) The deduction of \$500.00 claimed as a contribution to Coronado Horse Show is not allowable under the provisions of section 23 (o) or 23 (a) of the Internal Revenue Code.

Computation of Alternative Tax

Taxable Year Ended December 31, 1939

Net income adjusted	\$111,704.35
Plus: Net long-term capital loss.....	5,045.90
Ordinary net income	\$116,750.25
Less: Personal exemption.....	1,000.00
Balance (surtax net income).....	\$115,750.25
Less: Earned income credit.....	300.00
Net income subject to normal tax.....	\$115,450.25
Normal tax at 4% on \$115,450.25.....	\$ 4,618.01
Surtax on \$115,750.25.....	39,135.15
Partial tax	\$ 43,753.16
Minus: 30% of net long-term capital loss.....	1,513.77
Alternative tax	\$ 42,239.39

Computation of Tax

Taxable Year Ended December 31, 1939

Net income adjusted	\$111,704.35
Less: Personal exemption	1,000.00
Balance (surtax net income).....	\$110,704.35
Less: Earned income credit	300.00
Net income subject to normal tax.....	\$110,404.35
Normal tax at 4% on \$110,404.35.....	\$ 4,416.17
Surtax on \$110,704.35.....	36,788.52
Total	\$ 41,204.69
Alternative tax	\$ 42,239.39
Correct income tax liability.....	\$ 42,239.39
Income tax assessed: Original, account No. 203835.....	41,169.64
Deficiency of income tax.....	\$ 1,069.75

Adjustments to Net Income
Taxable Year Ended December 31, 1940

Net income as disclosed by return.....	\$ 11,696.14
Additional income: (a) Trust income.....	155,218.56
Total	<u>\$166,914.70</u>
Additional deduction: (b) Contributions.....	11,235.98
Net income adjusted	<u>\$155,678.72</u>

Explanation of Adjustments

(a) This represents additional income from trusts as follows:

Trust #5380:

Dividends received from J. D. and A. B. Spreckels Company	\$153,953.36
Disallowed expenses	779.87
Total	<u>\$154,733.23</u>

Trust #1173:

Disallowed expenses	485.33
Total	<u>\$155,218.56</u>

These adjustments have been previously explained.

(b) In view of the above adjustments the entire amount of \$13,300.00 listed in your return as contributions paid is deductible, in lieu of \$2,064.02 claimed in your return.

Computation of Alternative Tax
Taxable Year Ended December 31, 1940

Net income adjusted	\$155,678.72
Minus: Net long-term capital gain.....	3,705.99
Ordinary net income	<u>\$151,972.73</u>
Less: Personal exemption	800.00
Balance (surtax net income).....	<u>\$151,172.73</u>
Less: Earned income credit	300.00
Net income subject to normal tax.....	<u>\$150,872.73</u>
Normal tax at 4% on \$150,872.73.....	\$ 6,034.91
Surtax on \$151,172.73.....	66,483.64
Partial tax	<u>\$ 72,518.55</u>
Plus: 30% of net long-term capital gain.....	1,111.80
Alternative tax	<u>\$ 73,630.35</u>

Computation of Tax

Taxable Year Ended December 31, 1940

Net income adjusted	\$155,678.72
Less: Personal exemption	800.00
Balance (surtax net income).....	\$154,878.72
Less: Earned income credit.....	300.00
Net income subject to normal tax.....	\$154,578.72
Normal tax at 4% on \$154,578.72.....	\$ 6,183.15
Surtax on \$154,878.72.....	68,707.23
Total normal tax and surtax.....	\$ 74,890.38
Alternative tax	\$ 73,630.35
Defense tax (10% of \$73,630.35).....	7,363.04
Correct income tax liability.....	\$ 80,993.39
Income tax assessed: Original, account No. 879298.....	960.81
Deficiency of income tax.....	\$ 80,032.58

Received and filed July 17, 1944, T.C.U.S.

[Title of Tax Court and Cause.]

Docket No. 5560

ANSWER

Comes now the Commissioner of Internal Revenue, respondent above named, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition filed by the above-named petitioner, admits and denies as follows:

1. Admits the allegations contained in paragraph 1 of the petition.

2. Admits the allegations contained in paragraph 2 of the petition.

3. Admits that the taxes in controversy are income taxes for the calendar years 1938, 1939 and 1940; denies all other allegations contained in paragraph 3 of the petition.

4. (a) to (c), inclusive. Denies that the determination of tax set forth in the notice of deficiency is based upon errors as alleged in paragraph 4 and subparagraphs (a) to (c), inclusive, thereunder, of the petition.

5. (a) Admits that during the calendar years 1938, 1939 and 1940 petitioner was the beneficiary of a trust known as the Lillie S. Wegeforth Trust, Trust No. 5380, the First National Trust and Savings Bank of San Diego, Trustee, and as such beneficiary was entitled to receive the entire income of said trust during each of said years; admits that included in the assets of said trust during each of said years were shares of the capital stock of J. D. and A. B. Spreckels Company and voting trust certificates representing shares of the capital stock of said corporation; for lack of information and belief denies all other allegations contained in subparagraph (a) of paragraph 5 of the petition.

(b) Admits that during the calendar years 1938, 1939 and 1940 petitioner was a beneficiary of a trust known as the Lillie S. Wegeforth Trust, Trust No. 1173, Crocker First National Bank of San Francisco, Trustee, and as such beneficiary was entitled to receive income of said trust during each

of said years; admits that included in the assets of said trust during the calendar years 1938 and 1939 and the period January 1 to and including October 9, 1940, were voting trust certificates representing shares of the capital stock of J. D. and A. B. Spreckels Company; admits that included in the assets of said trust during the period October 10 to December 31, 1940, were voting trust certificates representing shares of the capital stock of J. D. and A. B. Spreckels Company; for lack of information and belief denies all other allegations contained in subparagraph (b) of paragraph 5 of the petition.

(c) Admits that during the calendar year 1938, J. D. and A. B. Spreckels Company made distributions to its stockholders; admits that petitioner filed an income tax return for the calendar year 1938 on March 15, 1939; for lack of information and belief denies all other allegations contained in subparagraph (c) of paragraph 5 of the petition.

(d) Admits that on February 27, 1942, petitioner filed a claim for refund (Form 843) of income taxes paid for the calendar year 1938 in the amount of \$15,578.82; admits that the Commissioner has failed to allow any portion of said claim for refund; for lack of information and belief denies all other allegations contained in subparagraph (d) of paragraph 5 of the petition.

(e) Admits that during the calendar year 1939, J. D. and A. B. Spreckels Company made distributions to its stockholders; admits that petitioner filed an income tax return for the calendar year

1939 on March 15, 1940; for lack of information and belief denies all other allegations contained in subparagraph (e) of paragraph 5 of the petition.

(f) Admits that on February 12, 1943, petitioner filed a claim for refund (Form 843) of income taxes paid for the calendar year 1939 in the amount of \$41,169.64; admits that the Commissioner has failed to allow any portion of said claim for refund; for lack of information and belief denies all other allegations contained in subparagraph (f) of paragraph 5 of the petition.

(g) Admits that during the calendar year 1940, J. D. and A. B. Spreckels Company made distributions to its stockholders; for lack of information and belief denies all other allegations contained in subparagraph (g) of paragraph 5 of the petition.

(h) Admits that said Trust No. 5380, The First National Bank and Savings Bank of San Diego, Trustee, received some of said distributions; for lack of information and belief denies all other allegations contained in subparagraph (h) of paragraph 5 of the petition.

(i) Admits that said Trust No. 1173, Crocker First National Bank of San Francisco, Trustee, received some of said distributions; for lack of information and belief denies all other allegations contained in subparagraph (i) of paragraph 5 of the petition.

(j), (k) and (l) Denies the allegations contained in subparagraphs (j), (k) and (l) of paragraph 5 of the petition.

(m) Admits that during the calendar year 1940

said Trust No. 5380, The First National Trust and Savings Bank of San Diego, Trustee, received from J. D. and A. B. Spreckels Company certain distributions; admits that during the calendar year 1940 petitioner received from J. D. and A. B. Spreckels Company through the medium of Trust No. 1173, Crocker First National Bank of San Francisco, Trustee, certain distributions; denies all other allegations contained in subparagraph (m) of paragraph 5 of the petition.

(n) and (o) Denies the allegations contained in subparagraphs (n) and (o) of paragraph 5 of the petition.

6. Denies generally and specifically each and every allegation in the petition not hereinbefore admitted, qualified, or denied.

Wherefore, it is prayed that the Commissioner's determination be approved and the petitioner's appeal denied.

/s/ J. P. WENCHEL,

Chief Counsel, Bureau of
Internal Revenue.

Of Counsel:

B. H. NEBLETT,
Division Counsel.

T. M. MATHER,

ARTHUR L. MURRAY,
Special Attorneys,
Bureau of Internal Revenue.

Received and filed Sept. 4, 1944, T.C.U.S.

[Title of Tax Court and Cause.]

Docket No. 5560

SUPPLEMENTARY STIPULATION
OF FACTS

It Is Hereby Stipulated and Agreed by and between the parties hereto, by their respective attorneys, that the following facts shall be taken as true upon the trial of the above-entitled case, provided, however, that this stipulation shall be without prejudice to the right of either party to introduce other and further evidence not inconsistent with the facts herein stipulated to be taken as true.

Petitioner at all times during the calendar years 1938, 1939 and 1940 was the beneficiary of a trust known as the Lillie S. Wegeforth Trust, Trust No. 5380, The First National Trust and Savings Bank of San Diego, Trustee, and as such beneficiary was entitled to receive the entire income of said trust during each of said years. Included in the assets of said trust during each of said years were 2 shares of the capital stock of J. D. and A. B. Spreckels Company and voting trust certificates representing 2,186 shares of the capital stock of said company. The distributions received by the trustee from said company were, under the terms of the trust, after deducting certain prior charges and expenses, currently distributable to the beneficiary. During said calendar years 1938, 1939 and 1940 the trustee made distributions as required by the terms of the trust and petitioner received from the trustee as petitioner's net share of said distribu-

tions of J. D. and A. B. Spreckels Company on said shares the following amounts:

Schedule A			
Year	Net	J. D. and A. B.	Net Bal. of Other Items
	Distribution by Trustees	Spreckels Company Dividends	
1/ 1/38 to 12/15/38		\$65,640.00	
12/22/38		27,350.00	
Total 1938	\$74,525.86	\$92,990.00	(\$18,464.14)
1939	121,435.95	120,340.00	1,095.95
1940	150,762.62	148,784.00	1,978.02

Petitioner at all times during the calendar years 1938, 1939 and 1940 was a beneficiary of a trust known as the Lillie S. Wegeforth Trust, Trust No. 1173, Crocker First National Bank of San Francisco, Trustee, and as such beneficiary was entitled to receive one-half of the income of said trust for said years. Included in the assets of said trust during the period January 1, 1938, to and including October 9, 1940, were voting trust certificates representing 1,146 shares of the capital stock of J. D. and A. B. Spreckels Company. Included in the assets of said trust during the period October 10 to and including December 31, 1940, were voting trust certificates representing 1,237 shares of the capital stock of J. D. and A. B. Spreckels Company. Distributions received by the trustee from said company were, under the terms of the trust, after deducting certain prior charges and expenses of the trust, currently distributable to the beneficiaries. During said years the trustee made distributions as required by the terms of the trust and petitioner received from the trustee as peti-

tioner's net share of the said distributions of J. D. and A. B. Spreckels Company the following amounts:

Schedule B

Year	Net Distribution by Trustees	J. D. and A. B. Spreckels Company Dividends	Net Bal. of Other Items
1/ 1/38 to 12/15/38		\$17,190.00	
12/22/38		7,162.50	
Total 1938	\$25,004.94	\$24,352.50	\$ 652.44
1939	32,358.33	31,515.00	843.33
1940	42,124.27	41,034.25	1,090.02

The parties are agreed that the portions of the dividends of J. D. and A. B. Spreckels Company for the years 1938, 1939 and 1940 which this Court determines in the case of Grace H. Kelham, Petitioner, vs. Commissioner of Internal Revenue, Respondent, Docket No. 5333, have been paid out of capital will in the case of this petitioner represent the portions of the respective amounts listed in the column entitled "J. D. and A. B. Spreckels Company Dividends" of Schedules A and B which are to be subtracted from the respective amounts listed in the columns entitled "Net Distributions by Trustees" of Schedules A and B in determining petitioners' taxable income for the years 1938, 1939 and 1940.

Dated this 31st day of October, 1947.

/s/ LEON de FREMERY,

Attorney for Petitioner.

/s/ CHARLES OLIPHANT,

Chief Counsel, Bureau of
Internal Revenue.

Filed at hearing Nov. 3, 1947, T.C.U.S.

The Tax Court of The United States
Washington
Docket No. 5560

LILLIE S. WEGEFORTH,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION

Pursuant to the Court's Findings of Fact and Opinion, promulgated December 20, 1949, the respondent herein filed a computation of tax on February 28, 1950, and the petitioner on the same date filed an acquiescence in the respondent's computation. In accordance therewith it is

Ordered and Decided: That for the year 1938 there is a deficiency in income tax of \$711.19;

That for the year 1939 there is an over-payment in income tax of \$33,821.09, which amount was paid within three years before the filing of a claim for refund;

That for the year 1940 there is a deficiency in income tax of \$1,321.03.

Enter:

[Seal] /s/ BOLON B. TURNER,
Judge.

Entered March 14, 1950.

Served March 15, 1950.

In the United States Court of Appeals
for the Ninth Circuit
T. C. Docket No. 5560

COMMISSIONER OF INTERNAL REVENUE,

Petitioner on Review,

vs.

LILLIE S. WEGEFORTH,

Respondent on Review.

PETITION FOR REVIEW

To the Honorable Judges of the United States
Court of Appeals for the Ninth Circuit:

The Commissioner of Internal Revenue hereby petitions the United States Court of Appeals for the Ninth Circuit to review the decision entered by The Tax Court of the United States on March 14, 1950, that there is an overpayment of income tax in the amount of \$33,821.09 for the year 1939 and a deficiency in income tax for the year 1940 in the amount of \$1,321.03 in respect of the Federal income tax liability of Lillie S. Wegeforth, the above-named respondent on review. This petition for review is filed pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code.

The respondent on review, Lillie S. Wegeforth, is a resident of California, whose mailing address is c/o The First National Trust and Savings Bank of San Diego, San Diego, California. Respondent's

Federal income tax returns for the calendar years 1939 and 1940, the taxable years here involved, were filed with the Collector of Internal Revenue for the Sixth District of California, whose office is located in Los Angeles, California, and within the jurisdiction of the United States Court of Appeals for the Ninth Circuit where this review is sought.

Nature of Controversy

During the calendar years 1938, 1939 and 1940 the respondent on review was the beneficiary of a trust known as the Lillie S. Wegeforth Trust, Trust No. 5380, among the assets of which trust were 2 shares of the capital stock of J. D. and A. B. Spreckels Company and voting trust certificates representing 2,186 shares of the capital stock of said company. As a part of the distributable income of said trust for the years 1938, 1939 and 1940, the respondent received from the trustees, as her net share of distributions made to the trust by the J. D. and A. B. Spreckels Company in 1938, 1939 and 1940 on said 2,188 shares, the respective sums of \$92,990.00 (less \$18,464.14 representing other items), \$120,340.00 and \$148,784.00.

Respondent was also the beneficiary of a trust known as the Lillie S. Wegeforth Trust, Trust No. 1173, among the assets of which trust during the period January 1, 1938, to and including October 9, 1940, were voting trust certificates representing 1,146 shares of the capital stock of J. D. and A. B. Spreckels Company, and included in the assets of which trust during the period October 10, 1940, to

and including December 31, 1940, were voting trust certificates representing 1,237 shares of the capital stock of J. D. and A. B. Spreckels Company. As a part of the distributable income of said latter trust for the years 1938, 1939 and 1940, the respondent received from the trustees, as her net share of distributions made to the trust by the J. D. and A. B. Spreckels Company in 1938, 1939 and 1940 on said shares, the respective sums of \$24,352.50, \$31,515.00 and \$41,034.25. In her Federal income tax returns for the years 1938 and 1939 the respondent returned the amounts so received during those years, but in her return for 1940 the respondent returned as taxable income only 18 per cent in respect of the distributions made to the trusts by the J. D. and A. B. Spreckels Company. In his redetermination of the respondent's tax liability for the year 1940 the Commissioner increased the distributions returned by the respondent to their full amounts.

It was the taxpayer's contention before The Tax Court of the United States, among other things, that in determining the percentages or amounts of the distributions made by the J. D. and A. B. Spreckels Company which represented taxable dividends in the hands of the recipients thereof it is necessary to first restore out of subsequent earnings and profits the pre-March 1, 1913, accumulated operating losses, or deficit, of the predecessor of J. D. and A. B. Spreckels Company and its affiliated companies. The Commissioner contended, on the other hand, that operating deficits as of March 1, 1913, may not be restored by subsequent earn-

ings and profits in determining the amount of earnings or profits accumulated after February 28, 1913, which would constitute taxable dividends to the recipients in whole or in part. The Tax Court of the United States disagreed with the Commissioner's determination and allowed the restoration of pre-March 1, 1913, accumulated operating losses for the purpose of determining the amount of subsequent earnings and profits available for distribution as taxable dividends, as a result of which allowances the overpayment of tax for the year 1939 and the reduced deficiency in tax for the year 1940 partly resulted.

There is now no dispute in respect of the tax liability for the year 1938 in so far as this petition for review is concerned.

/s/ THERON L. CAUDLE,

Assistant Attorney General.

/s/ CHARLES OLIPHANT,

Chief Counsel, Bureau of Internal Revenue, Attorneys for Petitioner on Review.

Received and filed June 2, 1950, T.C.U.S.

[Titles of Causes.]

T. C. Docket Nos. 5333, 5334, 5495, 5559 and 5560.

CERTIFICATE

I, Victor S. Mersch, Clerk of The Tax Court of the United States do hereby certify that the foregoing documents, 1 to 76, inclusive, constitute and are all of the original papers and proceedings on file in my office as the original and complete record in the proceedings before The Tax Court of the United States entitled: "Grace H. Kelham, Leila H. Neill, Ellis M. Moore, Harriet H. Belcher, Lillie S. Wegeforth, Petitioners, vs. Commissioner of Internal Revenue, Respondent," Docket Nos. 5333, 5334, 5495, 5559, 5560, respectively, and in which the respondents in The Tax Court proceedings have initiated appeals as above numbered and entitled, together with true copies of the docket entries in said Tax Court proceedings, as the same appear in the official docket book in my office.

In testimony whereof, I hereunto set my hand and affix the seal of The Tax Court of the United States, at Washington, in the District of Columbia, this 11th day of August, 1950.

[Seal] /s/ VICTOR S. MERSCH,
Clerk, The Tax Court
of the United States.

[Endorsed]: No. 12664. United States Court of Appeals for the Ninth Circuit. Commisisoner of Internal Revenue, Petitioner, vs. Grace H. Kelham, Leila H. Neill, Ellis M. Moore, Harriett H. Belcher, and Lillie S. Wegeforth, Respondents. Transcript of the Record. Upon Petitions to Review Decisions of The Tax Court of the United States.

Filed August 25, 1950.

/s/PAUL P. O'BRIEN,

Clerk of the United States Court of Appeals for the Ninth Circuit.

In the United States Court of Appeals
for the Ninth Circuit
No. 12664

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

GRACE H. KELHAM, LEILA H. NEILL, ELLIS
M. MOORE, HARRIET H. BELCHER,
LILLIE S. WEGEFORTH,
Respondents.

Tax Court Docket Nos. 5333, 5334, 5495, 5559 and
5560

STIPULATION

It is hereby stipulated by the parties, subject to the approval of the Court, that the above-entitled

cases may be consolidated for the purposes of the record, briefs, argument and decision.

/s/ THERON LAMAR CAUDLE,
Assistant Attorney General, Counsel for the Commissioner.

/s/ LEON de FREMERY,
Counsel for taxpayers.

Approved: October 24, 1950.

/s/ WILLIAM DENMAN,

/s/ WILLIAM HEALY,

/s/ HOMER BONE,

Judges, U. S. Court of Appeals for the Ninth Circuit.

[Endorsed]: Filed Oct. 26, 1950 U.S.C.A.

[Title of Court of Appeals and Cause.]

STATEMENT OF POINTS TO BE RELIED ON
AND DESIGNATION OF PORTIONS OF
THE RECORD TO BE PRINTED

Pursuant to Rule 19, Paragraph 6, Rules of the Court of Appeals for the Ninth Circuit, the following statement is made of the points on which the Commissioner intends to rely in the above-entitled cases:

The Tax Court erred in holding, under Section 115 of the Internal Revenue Code and of the applicable revenue acts, that earnings and profits of a

corporation accumulated after February 28, 1913, available for the distribution of taxable dividends, must be computed in such a manner that, where a deficit in earnings and profits existed on March 1, 1913, subsequent earnings and profits must first be applied to removing the deficit before there can be a surplus in such accumulated earnings and profits, and in failing to hold, under Section 115 of the Internal Revenue Code and of the applicable revenue acts, that the earnings and profits of a corporation accumulated after February 28, 1913, are to be computed without regard to any deficit in earnings and profits existing on March 1, 1913.

Pursuant to the same rule of the Court, the following designation is made of the portions of the record in the above-entitled cases which are considered material to the issue to be presented on review and which the Commissioner desires to have incorporated in the printed record:

Document No. 1—Docket Entries in Tax Court No. 5333.

Document No. 12—Stipulation of Facts Re Dividend Issue in Tax Court Nos. 5333, 5334, 5495, 5559, 5560.

Document No. 13—Supplementary Stipulation of Facts in Tax Court No. 5333.

Document No. 36—Supplementary Stipulation of Facts in Tax Court No. 5334.

Document No. 48—Supplementary Stipulation of Facts in Tax Court No. 5495.

Document No. 59—Supplementary Stipulation of Facts in Tax Court No. 5559.

Document No. 70—Supplementary Stipulation of Facts in Tax Court No. 5560.

Document No. 23—Opinion of Tax Court, together with concurring opinion of Judge Tyson and dissenting opinion of Judge Disney in Tax Court Nos. 5333, 5334, 5495, 5559, and 5560.

Document No. 25—Decision in Tax Court No. 5333.

Document No. 38—Decision in Tax Court No. 5334.

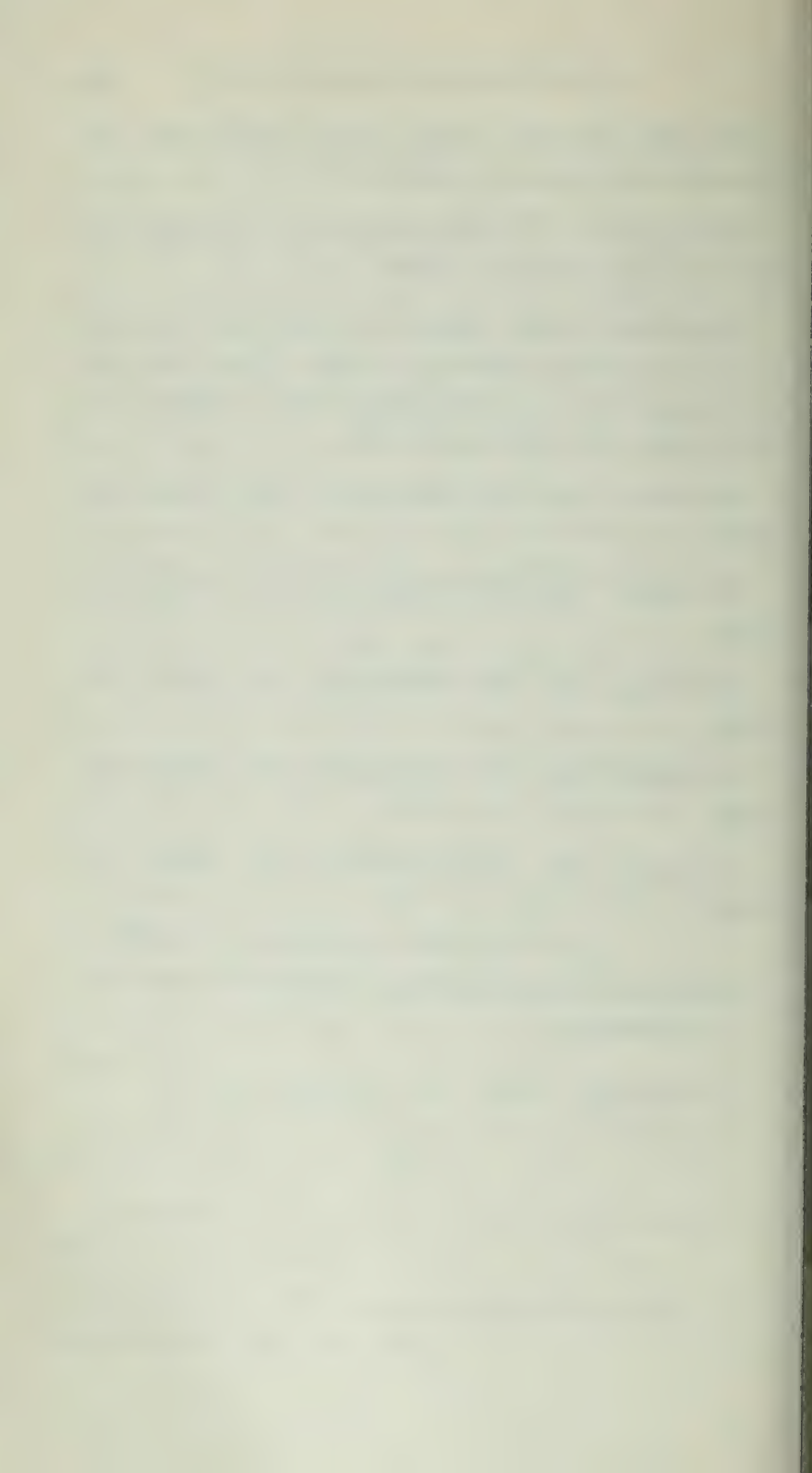
Document No. 50—Decision in Tax Court No. 5495.

Document No. 61—Decision in Tax Court No. 5559.

Document No. 72—Decision in Tax Court No. 5560.

/s/ THERON LAMAR CAUDLE,
Assistant Attorney General, Counsel for the Commissioner.

[Endorsed]: Filed Nov. 2, 1950 U.S.C.A.



No. 12664

**In the United States Court of Appeals
for the Ninth Circuit**

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

GRACE H. KELHAM, LEILA H. NEILL, ELLIS M. MOORE,
HARRIET H. BELCHER, AND LILLIE S. WEGEFORTH,
RESPONDENTS

ON PETITIONS FOR REVIEW OF THE DECISIONS OF THE
TAX COURT OF THE UNITED STATES

BRIEF FOR THE PETITIONER

THERON LAMAR CAUDLE,
Assistant Attorney General.

ELLIS N. SLACK,
HILBERT P. ZARKY,
Special Assistants to the Attorney General.

FILED

NOV 10 1931

PAUL A. CHAPMAN

CLERK



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**In the United States Court of Appeals
for the Ninth Circuit**

No. 12664

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

GRACE H. KELHAM, LEILA H. NEILL, ELLIS M. MOORE,
HARRIET H. BELCHER, AND LILLIE S. WEGEFORTH,
RESPONDENTS

*ON PETITIONS FOR REVIEW OF THE DECISIONS OF THE
TAX COURT OF THE UNITED STATES*

BRIEF FOR THE PETITIONER

OPINION BELOW

The opinion of the Tax Court (R. 64-98), together with the concurring opinion (R. 98-101), and the dissenting opinion (R. 102-117) are reported at 13 T.C. 984.

JURISDICTION

These consolidated cases involve asserted deficiencies in individual income taxes for the calendar years 1937-1940, inclusive, or for some of those years in the case of some of the taxpayers. Notices of deficiencies were mailed to the taxpayers on April 22, 1944 (R. 197-200), May 13, 1944 (R. 220-228), and on May 26, 1944 (R. 13-

17, 134-141, 169-178). Petitions for redetermination by the Tax Court of the United States were filed by the taxpayers, pursuant to the provisions of Section 272 of the Internal Revenue Code, on June 12, 1944 (R. 6-17, 122-141), July 5, 1944 (R. 155-178), and July 17, 1944 (R. 192-200, 209-228). The decisions of the Tax Court were entered on March 14, 1950. (R. 118, 150-151, 187-188, 205, 236.) The Commissioner filed petitions for review by this Court on June 2, 1950. (R. 119-121, 152-155, 189-192, 206-208, 237-240.) The jurisdiction of this Court rests on Section 1141 (a), Internal Revenue Code, as amended by Section 36 of the Act of June 25, 1948.

QUESTION PRESENTED

Section 115 (a)(1), Internal Revenue Code, defines a taxable dividend as a distribution by a corporation out of its earnings or profits accumulated after February 28, 1913. Section 115 (b), among other things, provides that earnings or profits accumulated before March 1, 1913, may be distributed tax-free after the earnings and profits accumulated after that date have been distributed.

The question is whether, in the case of a corporation having a deficit on February 28, 1913, the Tax Court was correct in construing Section 115 (a)(1) in such a way that its earnings after that date must first be devoted to eradicating the deficit before becoming available for distribution as taxable dividends.

STATUTES INVOLVED

The applicable provisions of the statutes involved are set forth in the Appendix, *infra*.

STATEMENT

During the taxable years 1938, 1939, and 1940, the taxpayers, who were stockholders of the J. D. and A. B.

Spreckels Company (referred to as Spreckels Company) received certain distributions from that company. The extent to which those distributions are taxable as dividends constitute the issue for decision. The parties below stipulated how much of the distributions in each year were to be taxed as dividends, depending on how the Tax Court resolved the three issues presented to it for decision, in any combination. (R. 23, 40-55.) Supplemental stipulations were also filed to cover the facts peculiar to each of the taxpayers. (R. 62-64, 147-150, 184-187, 203-204, 233-235.)

The only question on review relates to the Tax Court's decision on issue 2, below, namely, whether the operating deficits of Oceanic Steamship Company and Kilauea Sugar Plantation Company (wholly owned subsidiaries of the Spreckels Company) as of March 1, 1913, must be restored by subsequent earnings or profits in determining the amount of earnings or profits available for dividends. (R. 23.) The resolution of this question, the facts of which were also stipulated (R. 31-38), was relevant to determine what taxable dividends the Spreckels Company received from these subsidiaries in prior years and how much were the earnings and profits it inherited on the tax-free liquidation of Oceanic Steamship Company on November 18, 1936. These matters, in turn, affected the amount of the earnings and profits of the Spreckels Company available for the distribution of taxable dividends during the taxable years.

The Tax Court (R. 69-85), with Judges Disney, Arnold and Oppen dissenting (R. 102-117), held that the March 1, 1913, deficit of these subsidiaries had to be restored by subsequent earnings before there would be earnings or profits available for the distribution of taxable dividends.

STATEMENT OF POINTS TO BE URGED

The points to be urged by the Commissioner (R. 243-244) are that the Tax Court erred in deciding that the earnings and profits of a corporation accumulated after February 28, 1913, available for the distribution of taxable dividends, must be computed in such a manner that, where a deficit in earnings and profits existed on March 1, 1913, subsequent earnings and profits must first be applied to extinguishing the deficit before there can be a surplus in such accumulated earnings and profits.

SUMMARY OF ARGUMENT

Congress, by Section 115 (a)(1) of the Code, has provided that corporate distributions should be taxed as dividends to the extent made out of the corporation's earnings or profits accumulated after February 28, 1913. The Tax Court, in this case, however, has so construed the statute that, where the corporation possessed a deficit on February 28, 1913, its accumulated earnings and profits in each subsequent year must be calculated from the very beginning of its corporate history, and not only from the viewpoint of what has been accumulated subsequent to February 28, 1913, although the latter is what the statute specifies. The decision below holds that all subsequent earnings must first be devoted to eradicating the February 28, 1913, deficit before they can become available for distribution as dividends.

The Tax Court, just as if Congress had employed meaningless language in the legislation, construes Section 115 (a)(1) as though it contained no reference to earnings or profits accumulated "after February 28, 1913." There is no justification for this alteration in the statutory language. While Congress, in Section 115 (b), a separate subsection, has acted to exempt from tax the distribution of pre-1913 corporate earnings,

that action cannot possibly justify the conclusion that Section 115 (a)(1) does not mean what it says.

The exemption with respect to the distribution of pre-1913 earnings when the corporation possessed a surplus on that date is, on the contrary, specific in its nature and has been narrowly applied so as not to defeat the broader Congressional purpose of taxing the distribution of all post-1913 accumulations of corporate profits. This is the only exemption created by Congress and it has nothing to do with corporations possessing a deficit on the crucial date. The Tax Court, in reading a further exemption into the statute with respect to such corporations, namely, that their post-1913 earnings are first to be devoted to the 1913 deficit, has created an exemption where none was expressly provided by Congress and where there is no other indication that any was intended. Indeed, contrary to the general Congressional purpose, the decision here permits the distribution of post-1913 corporate earnings to escape tax as ordinary income in the hands of the distributees.

The Tax Court was wrong in believing that there must be an equation between the amount of a corporation's surplus, available for dividends as a matter of general corporate law, and the amount of its accumulated earnings and profits, available for the distribution of taxable dividends. In other respects, the courts have held that a divergence between these two, separate concepts is required to effectuate Congressional purposes, particularly the purpose that post-1913 accumulated earnings be taxed to the shareholders when distributed. For the same reason, plus the additional reason that the statute introduces February 28, 1913, as a critical date, which would not be true in corporate accounting, such a divergence is required in this kind of case.

The result reached by the Tax Court gains no stature from its reliance on the word "accumulated." Contrary to the Tax Court, the amount of earnings accumulated after February 28, 1913, is not the same as what has been accumulated from the very start of the corporation's history. Nor do the authorities relied on by the Tax Court support its conclusion in any degree. Indeed, in one case, the Court of Appeals, while it did not analyze the point, actually applied the statute in a contrary manner to that required by the Tax Court.

ARGUMENT

The Earnings or Profits of a Corporation Accumulated After February 28, 1913, Which Are Available for the Distribution of Taxable Dividends, Are Not Affected by a Deficit Existing on February 28, 1913

A. Preliminary.

The ultimate legal issue presented by these consolidated cases concerns the proper construction of Section 115 (a)(1) of the Internal Revenue Code (Appendix, *infra*) which, in defining the term "dividend," determines what corporate distributions are taxable as dividends, i.e., as ordinary income, to the recipients. Particularly, that section defines a corporate distribution as a dividend if it is made out of the corporation's "earnings or profits accumulated after February 28, 1913." The question here arises in circumstances where a corporation possessed a deficit in its earnings and profits account on February 28, 1913, but subsequently earned sufficient profits which exceed all subsequent distributions. It is the Commissioner's position that such distributions are to be regarded as dividends, and taxable as such to the shareholders under Code Section 22 (a) (Appendix, *infra*), because they are paid out of "earnings or profits accumulated after February 28, 1913," within the precise language of Section 115

(a)(1). The majority of the Tax Court, however, held that such a corporation must first devote its post-March 1, 1913, earnings to removing the pre-existing deficit before it can possess earnings or profits available for the distribution of dividends. (R. 69-85.) Judge Disney wrote a dissenting opinion which was agreed with by Judges Arnold and Oppen. (R. 102-117.)

The Tax Court's construction of Section 115 (a)(1), as will become readily apparent, does violence to the statutory language, for it renders completely superfluous the reference there to earnings or profits accumulated "after February 28, 1913," a reference which, beginning with the Revenue Act of 1916, c. 463, 39 Stat. 756, has appeared in every succeeding Revenue Act and in the Internal Revenue Code. The liberties which the Tax Court took with the legislative language not only go far beyond the only Congressional exception, namely, that corporate earnings accumulated before the time that the Income Tax Act of 1913 became effective¹ should be tax-free when distributed, but also undermines the legislative purpose that all distributions of corporate earnings accumulated after that time should be taxed as dividends to the stockholders. The novel construction of the statute embodied in the opinion below, as will be shown, is unsupported by any persuasive authority.

The taxpayers here are stockholders of the J. D. and A. B. Spreckels Company, which will be referred to as the Spreckels Company, who received distributions from that corporation in 1938, 1939, and 1940; the extent to which those distributions are taxable as dividends to those stockholders forms the nub of the

¹ That Act, c. 16, 38 Stat. 114, while enacted on October 3, 1913, levied a tax (Section IID) on income accruing after March 1, 1913.

tax controversy.² This is dependent on the amount of earnings and profits of the Spreckels Company available for the payment of taxable dividends at the time when the distributions in question were made, and this, in turn, is dependent on the extent to which taxable dividends were received by Spreckels Company in prior years from two wholly owned subsidiaries, Oceanic Steamship Company and Kilauea Sugar Plantation Company, and also on the amount of Oceanic's earnings and profits which passed to the Spreckels Company when the former was liquidated in 1936. (R. 31-38.) Since both subsidiaries possessed deficits in their earnings and profits account on March 1, 1913 (R. 31), and since the proper effect of those deficits on the subsequently accumulated earnings and profits of the subsidiaries (and consequently on those of Spreckels Company) made a difference in the extent to which the taxpayers received taxable dividends, the question for decision concerns the proper treatment of these March 1, 1913, deficits of the subsidiary companies. The parties stipulated in the Tax Court concerning the character of the distributions in question, depending on how the principal issue was resolved, and depending on the resolution of two other issues by the Tax Court which are not in issue on review. (R. 40-56.) As we have seen, the Tax Court ruled that the deficits were required to be absorbed by subsequent earnings before the subsidiaries could possess any earn-

² The consolidated cases of *Commissioner v. Adolph B. Spreckels, Dorothy C. Spreckels, Spreckels-Rosekrans Investment Co., John N. Rosekrans, and Alma Spreckels Rosekrans* (consolidated in Docket No. 12663), and *Commissioner v. Alma de Bretteville Spreckels* (formerly *Alma Spreckels Aul*) (Docket No. 12657), pending in this Court on the Commissioner's petitions for review, involve the same question as it relates to distributions to other stockholders of the Spreckels Company. Those cases, pursuant to stipulation, are being held in abeyance pending final decision in the present cases.

ings or profits accumulated subsequent to March 1, 1913.

The problem presented can best be understood in the light of the history of the statutory definition of the term "dividend," and its constant focus on February 28, 1913, as a point of reference. The Income Tax Act of 1913, *supra*, passed shortly after the adoption of the Sixteenth Amendment to the Constitution and levying a tax on income accruing after March 1, 1913, defined income (Section II B) to include dividends, but did not specify what the word "dividend" meant. In *Lynch v. Hornby*, 247 U. S. 339, it was ruled that under the 1913 Act, a corporate distribution made after March 1, 1913, constituted taxable income to the shareholders even though the dividend had been paid out of corporate profits earned prior to the adoption of the constitutional amendment; the Court found no constitutional obstacle to prevent Congress from taxing such distributions as ordinary income to the distributees. However, while *Lynch v. Hornby* was still pending in the lower courts, Congress, by Section 2 (a) of the Revenue Act of 1916, *supra*, incorporated a provision which limited dividend income to distributions out of "earnings or profits accrued since" March 1, 1913, and, by Section 1211 of the Revenue Act of 1917, c. 63, 40 Stat. 300, added Section 31 (a) and (b) to the 1916 Act,³ subsection (a) defining a dividend in terms of distributions from earnings and profits accrued since March 1, 1913, and subsection (b) provid-

³ Section 1200 of the 1917 Act amended Section 2 (a) of the 1916 Act (similar to Section 22 (a) of the Internal Revenue Code (Appendix, *infra*), and corresponding provisions of prior Acts) so as to contain a definition of income which included "dividends" and so as to remove the existing provision respecting earnings and profits accrued since March 1, 1913. The statutory pattern has since remained the same, namely, a definition of income to include dividends, and a separate definition of dividends.

ing that "nothing herein shall be construed as taxing any earnings or profits accrued prior to" March 1, 1913, but that such earnings could be distributed exempt from tax "after the distribution of earnings and profits accrued since" March 1, 1913, had been made, and also stating that all corporate distributions "shall be deemed to have been made from the most recently accumulated undivided profits or surplus * * *."

The difference thus drawn in the 1916 Act and the 1917 amendment between corporate accumulations before and after March 1, 1913, while not required by the Sixteenth Amendment, was stated in *Lynch v. Hornby*, *supra*, p. 346, to be a Congressional "concession to the equity of stockholders." From that time on, however, in all succeeding Revenue Acts and in the Internal Revenue Code, despite other changes in the definition relating to dividends, Congress has not only provided that distributions made out of earnings and profits accumulated *prior* to March 1, 1913, *should not* be taxed as dividends, but it has also specifically provided that distributions out of earnings and profits accumulated *after* that date *should be* taxed as dividends to the distributees.

The substance of these provisions of the 1916 Act and of the 1917 amendment appears in Section 115 (a) and (b) of the Code (Appendix, *infra*) in the following language:

DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend*.—The term "dividend" when used in this chapter * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, * * *

(b) *Source of Distributions*.—For the purposes of this chapter every distribution is made out of

earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

B. The Tax Court has erroneously construed Section 115 (a) (1) by ignoring the statutory reference to earnings or profits accumulated "after February 28, 1913."

The Commissioner contends that the definition of a dividend in terms of earnings or profits accumulated "after February 28, 1913" in Section 115 (a) (1) was intended to be meaningful, and that, if the quoted language is not to be ignored completely, it can only signify that earnings and profits accumulated after that critical date are available for distribution as taxable dividends. Contrary to the Tax Court, it cannot mean that, where the corporate existence antedated February 28, 1913, only such earnings and profits as have been accumulated from the very beginning of the corporation's life (rather than those accumulated after February 28, 1913) are distributable as taxable dividends.

The Tax Court, as we have stated, construes Section 115 (a) (1) to mean that, where a corporation possessed a deficit in earnings and profits on February 28, 1913, such deficit must first be eliminated by subsequent earnings before there can be any accumulated earnings and profits available for the distribution of taxable dividends. In other words, according to the Tax Court, in the case of such a corporation, the entire history of its accumulations, and not merely those made since

1913, must be examined to determine whether subsequent distributions are to be considered as taxable dividends.

The answer was well put by the dissenting opinion below which stated (R. 107):

But this only amounts to the argument that on this tax question, before taxable dividends can be paid, there must be net profits from the inception of the corporation, and that though Congress defined a dividend as from accumulations after February 28, 1913, and used "accumulated" to refer to two distinct periods, before and after that date, yet the word must be held to refer to and encompass the whole corporate life so that, for present tax purposes, there is no accumulation of earnings and profits because of capital impairment in the earlier period. But the statute does not say "profit" or "net profit" or "net profit [or net accumulations] over corporate life," but only "earnings or profits accumulated after February 28, 1913." * * *

If Congress had intended what the Tax Court has here held, the phrase "accumulated after February 28, 1913" in Section 115 (a) (1) would have to be rejected as though it were meaningless legislative verbiage. That is, the construction reached by the Tax Court would have been no different if Section 115 (a) (1), making no reference to February 28, 1913, had simply defined a dividend as a distribution out of the corporation's "accumulated earnings or profits." If the statute had so provided, it would have been sensible to conclude that Congress was referring to the corporation's net accumulations measured over the entire period of its history. But that is not what the statute says. In speaking of what was accumulated *after* a certain date, the statute cannot properly be construed so that the date specified by the legislature loses all significance.

It is no answer to say that Congress was thinking in terms of corporations which possessed a surplus on March 1, 1913, and was seeking to protect the pre-1913 surplus from being taxed as a dividend when distributed. That protection is completely provided by Section 115 (b) which is sufficient, by itself, to insure that the stockholders will not be taxed when pre-March 1, 1913, earnings are distributed, and that such distributions will not be deemed to be made until all post-February 28, 1913, earnings have first been distributed. Congress, as we have seen, has incorporated this protection in a separate subsection ever since the 1917 amendment to the 1916 Act.

The separate language of Section 115 (a) (1), consequently, neither serves the purposes which are in fact accomplished by Section 115 (b), nor may such language be ignored in ascertaining the intent of this separate subsection. If some Congressional meaning is to be given to all of Section 115 (a) (1), including the reference there to February 28, 1913, the construction adopted by the Tax Court must be rejected. Otherwise, it must be concluded that, despite other subsequent revisions, Congress has, ever since 1917, been repeatedly incorporating senseless language in the statutes.

The situation would seem to call for the application of the usual rule of statutory construction to the effect that all the words of a statute are to be given meaning, if possible, and that the legislature is not to be deemed to have inserted surplusage into the statutes. *Market Co. v. Hoffman*, 101 U. S. 112, 115-116; *Platt v. Union Pacific R. R. Co.*, 99 U. S. 48, 58-59; *Pacific Gas & Elec. Co. v. Securities & Exchange Com'n*, 127 F. 2d 378, 382, on review by the Court *en banc*, 139 F. 2d 298 (C.A. 9th), affirmed *per curiam*, 324 U. S. 826.

The Tax Court's confusion with respect to these separate subsections is evident from its statement that (R. 82)—

the statutory provision providing that pre-March 1, 1913, earnings or profits may be distributed, tax free, in no way affects the general rule stated and gives no basis for any conclusion that Congress, in recognizing, as the Supreme Court stated in *Lynch v. Hornby*, *supra*, the equity of stockholders as to pre-March 1, 1913, earnings, intended to legislate with respect to restoration or non-restoration of capital which has been impaired by operating losses. * * *

The point of the matter is that, as we have seen, Section 115 (b) deals with the tax-free distribution of pre-1913 earnings; it is complete by itself to accomplish this Congressional policy. We agree that Section 115 (b), dealing as it does with corporations having a surplus on March 1, 1913, does not itself evidence any legislative intent respecting corporations whose capital was impaired on that date. Section 115 (b), however, does not stand alone; the provisions of Section 115 (a)(1), and the reference there to earnings and profits accumulated after March 1, 1913, cannot be ignored or considered as echoing the provisions of Section 115 (b), as the Tax Court did. While Section 115 (b) evidences one Congressional policy with respect to pre-1913 earnings, Section 115 (a)(1) embodies a different legislative purpose, namely, to tax the distribution of all profits earned subsequent to March 1, 1913. The conclusion is inescapable that the legislature in Section 115 (a)(1) made it manifest that an absence or deficiency in earnings and profits on February 28, 1913, is without any significance in determining what earnings and profits are accumulated thereafter.

If Congress had intended the meaning which the Tax Court has read into the statute, the section, as we have

already observed, would have been drafted differently. Section 115 (b) would have remained the same, thus insuring that earnings or profits accumulated before March 1, 1913, could be distributed tax-free after the distribution of profits accumulated subsequent to that time. But Section 115 (a)(1) would have been different if, in the case of corporations having a deficit on March 1, 1913, Congress had intended to tax only such distributions which were subsequently made out of accumulated earnings or profits, measured over the whole of the corporation's life. To accomplish this, Section 115 (a) would only have had to refer to the accumulated earnings or profits of a corporation—not to those accumulated after March 1, 1913.

C. The Tax Court's construction of the statute creates an exemption where none was intended by Congress and is opposed by the Congressional policy of taxing as dividends all distributions of post-1913 corporate profits.

The construction adopted by the Tax Court not only renders meaningless the reference to earnings and profits "accumulated after February 28, 1913," but it results in stretching an exemption (which was created by Congress in Section 115 (b) to cover only a limited area) to make it cover an altogether different and broader situation under Section 115 (a)(1). That is, in making this "concession to the equity of stockholders" (*Lynch v. Hornby*, p. 346), so that pre-March 1, 1913, accumulations of earnings would not be taxed when distributed, Congress created a specific and limited exception in Section 115 (b) which has been narrowly construed (*Helvering v. Canfield*, 291 U. S. 163). By providing, however, that corporate distributions should be deemed to be made from the most recently accumulated earnings and profits, and that the distribu-

tion of pre-March 1, 1913, earnings should be tax-free only after all earnings and profits accumulated subsequent to February 28, 1913, have been distributed, Section 115 (b) makes it manifest that the exemption with respect to the pre-March 1, 1913, earnings must be limited so as not to interfere with the broad, parallel Congressional purpose not to permit "profits accumulated after that date to escape taxation." *Helvering v. Canfield*, *supra*, p. 168.

From this limited exemption under Section 115 (b), relating to corporations with a surplus on March 1, 1913, the Tax Court by a complete *non-sequitur*, creates a different exception under Section 115 (a)(1) for corporations possessing a deficit on that date. And, despite a Congressional purpose to tax, when distributed, all earnings subsequently accumulated, the Tax Court reaches the strange result that the stockholders of a corporation which had a deficit on March 1, 1913, stand in a preferred position.

It was one thing for Congress, as it did in Section 115 (b), to act out of regard for the stockholder's equity in pre-March 1, 1913, earnings when the corporation possessed a surplus on that date, and to exempt such earnings from taxation when distributed. But it would have been an altogether different matter for Congress to have provided that, where the corporation possessed a deficit on that date, a stockholder should first have his 1913 equity restored to what it would have been if the corporation had not actually possessed a deficit. The Tax Court, in reading such a requirement into the statute, has extended a guarantee to the stockholders that a March 1, 1913, deficit will be restored out of subsequent earnings before any distributions will be taxed—a guarantee that has no support either in the purpose or language of the statute.

Congress, on the contrary, did not even guarantee under Section 115 (b) that a March 1, 1913, surplus would remain intact for tax-free distribution to the shareholders. Thus, in *Helvering v. Canfield, supra*, the corporation had a surplus of some \$4,000,000 on March 1, 1913, a small profit in 1914, a loss of over \$190,000 in 1915, a loss of over \$200,000 in 1916, and profits of more than \$2,400,000 from 1917 to 1923. The taxpayer contended that its earnings and profits which were accumulated after March 1, 1913, had to take into account the 1915 and 1916 losses, so that those would not reduce the amount of its March 1, 1913, earnings and profits which could be distributed free of tax. The Supreme Court held, however, that the 1913 surplus was in fact diminished by the 1915 and 1916 losses, and that the later profits, in their entirety, were accumulated after March 1, 1913, and available for distribution as taxable dividends. In so holding, the Court said that the statutory provisions there, similar to those embodied in Code Section 115 (a) and (b) (p. 168)—

disclose a single purpose and are to be construed in harmony with each other. They show that the Congress was careful to arrange its plan so that the right to receive, free of tax, a distribution of surplus accumulated prior to March 1, 1913, should not be exercised in such a fashion as to permit profits accumulated after that date to escape taxation. * * *

The Court also said, in referring to the Congressional recognition of the stockholder's equity in earnings accumulated prior to March 1, 1913, and the statutory privilege of receiving distributions of such earnings free of tax, that (p. 168)—

that equity is not apparent when those profits had been lost in whole or in part and immunity is sought

from the taxation of an equivalent amount of profits subsequently earned.

Since Congress, despite its express statutory concern with the stockholder's equity where the corporation possessed a surplus on March 1, 1913, did not warrant that this surplus would remain intact for tax-free distribution, or intend that future earnings should be devoted to restoring an intervening diminution of this surplus before being considered as a post-1913 accumulation available for dividend purposes, it is inconceivable that, despite its lack of any statutory concern with a corporation possessing a deficit on March 1, 1913, Congress should have simultaneously intended that the subsequent earnings of such a corporation should first be devoted to its deficit before being considered as a post-1913 accumulation available for taxable dividends.

The Tax Court has plainly misconceived the March 1, 1913, reference point in the statute. As the Court observed in *Helvering v. Credit Alliance Corp.*, 316 U. S. 107, 111, that date is "The line drawn in all of the revenue acts between profits accumulated before the enactment of the first income tax act and after that date, for distinguishing capital and income * * *."

To the limited extent that it created an exemption with respect to corporate distributions of pre-1913 accumulations, Congress treated the stockholder's share in such surplus as though it were a return of capital. *Helvering v. Canfield*, *supra*, pp. 169-170; *Foster v. United States*, 303 U. S. 118, 121. See also H. Rep. No. 179, 68th Cong., 1st Sess., p. 11 (1939-1 Cum. Bull. (Part 2) 241, 249), where in reporting on the Revenue Act of 1924, the Committee on Ways and Means observed: "The theory which causes the allowance of the receipt of the dividend free of tax is that this distribution, being out of earnings accumulated prior to March 1, 1913, constitutes a return of capital to the stockholders."

Such a statutory concept of March 1, 1913, capital where a surplus existed on that date can scarcely be extended to include a stockholder's interest in a surplus which did not exist on that date, i.e., the corporate deficit, or lead to the conclusion that post-1913 earnings are to become pre-1913 capital. Yet, the Tax Court here has held, in effect, that profits earned by the corporation after March 1, 1913, nevertheless represent part of the statutory capital of the stockholder which existed on March 1, 1913.

Actually, the limited Congressional concern with pre-1913 earnings negates the conclusion that Congress should have intended any larger exemption with respect to post-1913 accumulations by corporations having a deficit on the critical date. Indeed, the *Canfield* case illustrates how Congress was intent on taxing all post-1913 accumulations when distributed. The same idea was repeated in *Foster v. United States*, *supra*, pp. 120-121, where the Court said:

We are urged so to expand and broaden an exemption granted by Congress as a "concession to the equity of stockholders" that such concession would in reality serve to nullify and defeat the tax on corporate profits earned after 1913. Courts should construe laws in harmony with the legislative intent and seek to carry out legislative purpose. With respect to the tax provisions under consideration, there is no uncertainty as to the legislative purpose to tax post-1913 corporate earnings. We must not give effect to any contrivance which would defeat a tax Congress plainly intended to impose. * * *

It is quite apparent that the Tax Court, in construing the statute so that post-1913 earnings will not be considered as accumulations available for taxable dividends until after they have been devoted to a March 1,

1913, deficit, has permitted such earnings to escape taxation, contrary to the general intention of Congress.

While Congress, though not required to do so under the Constitution, has acted to exempt from tax any distribution of corporate earnings accumulated before March 1, 1913, there is no sound reason why it should not have taxed all distributions from subsequently accumulated earnings. And, quite clearly, there was no constitutional requirement that such subsequent earnings should first be applied to a March 1, 1913, deficit, if one existed. Indeed, under Code Section 115 (a), clause (2), which had its origin in the same section of the Revenue Act of 1936, c. 690, 49 Stat. 1648, any corporate distribution is taxable as a dividend to the extent that there are "earnings or profits of the taxable year," regardless of the fact that the corporation, at the time of the distribution, actually possesses a current deficit in accumulated earnings and profits. The validity of this has never been questioned. By like token, Congress possessed full authority to tax the distribution of post-1913 accumulations of earnings or profits, regardless of the existence of a pre-1913 deficit.

Even if these positive matters did not so conclusively demonstrate the error of the decision below, a rejection of the Tax Court's construction of the statute would nevertheless be required. Section 22 (a) of the Code includes "dividends" as one of the sources of a taxpayer's income. The sweeping definition of gross income in Section 22 (a) had frequently been held to represent an exercise by Congress of its full constitutional authority to impose a tax on income from whatever source derived. *Irwin v. Gavit*, 268 U.S. 161, 166; *Douglas v. Willcutt*, 296 U.S. 1, 9; *Helvering v. Clifford*, 309 U.S. 331, 334; *Commissioner v. Smith*, 324 U.S. 177, 181, rehearing denied, 324 U.S. 695. While, by exemptions, and other exceptions, Congress has elsewhere

refrained from taxing certain items of income which might be taxed under the Constitution, the result of the broad definition of gross income in Section 22 (a) is that no income which might be taxed under the Constitution can escape taxation except where Congress has specifically created an exception.

Since the kind of distributions here in issue could be constitutionally taxed, the question to be answered is whether an exemption exists of the kind which the Tax Court has read into the statute. In this connection, it must be borne in mind, as the dissenting opinion below correctly observed (R. 105-106), that exemptions are to be strictly interpreted, they cannot rest on implication, and a taxpayer, to be entitled to an exemption, must show that he has plainly been touched by the legislative grace. *Commissioner v. Jacobson*, 336 U.S. 28, 49; *Helvering v. Northwest Steel Mills*, 311 U.S. 46, 49; *United States v. Stewart*, 311 U.S. 60, 71. From what we have already demonstrated with respect to the statute, we believe that it is plain that these conditions do not exist. An analysis of the Tax Court's opinion, and the matters on which it rests, moreover, fails to disclose any basis on which an exemption can be implied from the statute, even if an exemption could legitimately rest on mere implication.

D. The matters relied on by the Tax Court do not support its construction of the statute.

The Tax Court, in its opinion (R. 71-83), relies heavily on the fundamental proposition that, as a matter of general corporation law, a corporation whose capital has been impaired cannot possess a surplus for distributing dividends so long as its capital remains impaired. It stated that the Commissioner's contention (R. 71) "is plainly contrary to fundamental principles of corporation law."

This, however, carries not the slightest weight of persuasion since the Congressional definition of a dividend and its concept of earnings and profits, for tax purposes, depart in many respects from principles of general corporation law and from corporate accounting practices. Thus, in *Commissioner v. Wheeler*, 324 U.S. 542, 546, the amount of the corporation's earnings and profits was different than that which would have resulted if general principles of corporation law had been followed, the Court saying:

But "earnings and profits" in the tax sense, although it does not correspond exactly to taxable income, does not necessarily follow corporate accounting principles either.

Again, in *Commissioner v. Phipps*, 336 U.S. 410, 420-421, it was held that the deficit of one corporation was not "inherited" by another corporation, even though it acquired the assets of the former in a tax-free exchange;⁴ the Court rejected the argument that the tax consequences ought to follow corporate accounting practices, saying:

The answer is brief. The *Sansome* rule itself, as applied to earnings and profits, has never been thought to be controlled by ordinary corporate accounting concepts; its uniform effect is to treat for tax purposes as earnings or profits assets which are properly considered capital for many if not most corporate purposes, and it has long been a commonplace of tax law that similar divergences often occur. * * *

⁴ The *Phipps* case was followed by the Tax Court as it related to one of the issues below, namely, whether the earnings and profits of the Spreckels Company was to be reduced by the deficits of the Monterey County Water Company, and Seventh and Hill Building Corporation, wholly owned corporations, which were liquidated in tax-free transactions. (R. 97-98.)

In the *Wheeler* and *Phipps* cases, *supra*, and also in *Commissioner v. Munter*, 331 U.S. 210, where the Supreme Court gave its sanction to the rule of *Commissioner v. Sansome*, 60 F. 2d 931 (C.A. 2d), namely, that a corporation does “inherit” the accumulated earnings and profits of another when it acquires its assets in a tax-free exchange, there was a divergence between accumulated earnings and profits under Section 115, for tax purposes, from what would be true under corporation accounting principles. This divergence and, indeed, the difference between the *Phipps* and *Munter* cases (holding that, in a tax-free acquisition of a corporation’s assets, its earnings and profits are inherited by the transferee but that a deficit is not) reflect the Congressional purpose of taxing to the shareholders any distribution of accumulated corporate earnings, and of insuring that none should be distributed free from the normal income tax, except as Congress has expressly provided to the contrary.

The Tax Court, accordingly, was wrong in believing that here there must be an equation between the amount of the corporation’s surplus, under general corporate accounting principles, and the amount of its earnings and profits, under taxation principles. On the contrary, as was true in the above cited cases, a divergence between the two is also required here in order to give meaning to the reference to February 28, 1913, in Section 115 (a) (1), and to give effect to the Congressional purpose not to permit “profits accumulated after that date to escape taxation.” *Helvering v. Canfield*, *supra*, p. 168.

The Tax Court attempted to bolster its reliance on corporate accounting principles by emphasizing the idea (R. 76-85) that there can be no “accumulation” of earnings or profits while a pre-1913 deficit is still extant. A somewhat similar accentuation of the word “ac-

accumulated" was made by the taxpayer in *Helvering v. Canfield, supra*, where the Court, in rejecting the taxpayer's argument, said (p. 169): "The argument for the stockholders stresses the word 'accumulated.' We think that the expression is made to carry too heavy a burden." That retort is even more apt here where, in concentrating on the word "accumulated," the Tax Court completely ignored the period during which Congress made the accumulations relevant for tax purposes. As we have already observed, Congress legislated from the standard of what earnings or profits were accumulated after February 28, 1913, while the Tax Court insisted on making the calculation extend back to the very beginning of the corporation's life.

The Tax Court, in this connection, also relied (R. 76-83) on the authorities which hold that, where a corporation incurs a deficit subsequent to March 1, 1913, there can be no accumulation of earnings and profits after that time until the deficit has been removed. We do not question those decisions. Indeed, they illustrate that the statute means what it says when it speaks of "earnings or profits accumulated after February 28, 1913," for any deficit (computed in the tax sense rather than by corporate principles) occurring after March 1, 1913, necessarily determines how much of the subsequent profits can become translated into earnings or profits accumulated after that time.

The Tax Court's mistake, however, was in thinking that these cases, involving corporations with a surplus on March 1, 1913, were (R. 82) "equally applicable to impairment of capital *whenever* suffered or sustained * * *." (Italics supplied.) On the contrary, Section 115 (a)(1), in focusing on earnings and profits accumulated after March 1, 1913, makes pregnant the very distinction between the situations which the Tax Court considers to be insignificant. The amount of earnings

and profits which are accumulated by a corporation after March 1, 1913, is definitely affected by any operating deficit occurring after the critical date. But for the many reasons already mentioned, the amount of profits accumulated after March 1, 1913, cannot be affected by a deficit existing before that date.

It is noteworthy that, among the cases cited by the Tax Court for the proposition that there can be no accumulation of earnings or profits while an impairment of capital exists (R. 76) is *Hadden v. Commissioner*, 49 F. 2d 709 (C.A. 2d), where, in fact, the Court of Appeals, to the extent that there was a March 1, 1913, deficit, assumed the exact opposite. There the corporation had a deficit on March 1, 1913, in excess of \$500,000. From that date until 1917, it had additional losses of approximately \$330,000. During 1917 it had net profits of about \$450,000 and the tax on its 1917 profits was about \$54,000. In determining what portion of a 1917 distribution was taxable as a dividend, the court held that the earnings and profits accumulated since March 1, 1913, and available for distribution as a dividend must take into account the operating losses incurred since March 1, 1913. Significantly, although the Tax Court overlooked this completely, the circuit court did not deduct the \$500,000 deficit which existed on March 1, 1913, in determining the amount of earnings or profits accumulated since that time.

The court in the *Hadden* case (p. 711) used the following broad language, which was relied on (R. 81) by the Tax Court to support its conclusion:

No earned surplus can be accumulated until the deficit or impairment of paid-in capital has been made good. Dividends paid while there is an operating deficit should be deemed to be from capital or paid-in surplus even though there are earnings of the taxable year sufficient to pay the dividend in whole or in part. * * *

The Tax Court failed to appreciate, however, that this broad language was limited to deficits arising after March 1, 1913. This is evident not only from the fact that the court in the *Hadden* case did not take the 1913 deficit into account in its calculations, but also from the ensuing statement in its opinion to the effect that (p. 711)—

the accumulated profits since March 1, 1913, must necessarily mean the net excess of all profits between March 1, 1913, and the date of distribution, *less all losses sustained between the same dates*
* * *. (Italics supplied.)

It is true that in the *Hadden* case the court assumed, without discussing the point, that the existence of the March 1, 1913, deficit had no effect on the amount of earnings and profits subsequently accumulated. The result there, however, is consistent with the Commissioner's position and can scarcely be deemed an authority which supports the Tax Court's conclusion. Moreover, it is a significant illustration why the authorities relied on by the Tax Court are not at all opposed to the Commissioner's contentions and why the Tax Court's reasoning embodies a patent *non-sequitur*.

So far as we have been able to ascertain, the problem of the present case was involved in the facts of only two other cases.⁵ In each, however, the issue was

⁵ In the taxpayers' brief in the Tax Court the following statement was made (pp. 24-25):

To construe the statute to mean that such a distribution is taxable to the recipient as income would raise serious constitutional problems, *which no doubt explains why such a construction of the statute has never heretofore been advanced by the Treasury Department, so far as we have been able to ascertain.* (Italics supplied.)

The underscored language might lead to the inference that the present cases represent the first time in the long history of the taxing statute that the Commissioner has invoked the construction of the statute on which we rely. Such an inference would be altogether

merely lurking, and the question was not raised directly; in neither did it become a matter to which the decision gave a direct answer. In *Hoffman v. United States*, 53 F. 2d 282 (C. Cls.), the corporation had a deficit on March 1, 1913, and the court, as in the *Hadden* case, *supra*, also assumed that subsequent earnings were available for distribution as taxable dividends without regard to the prior deficit. Thus, the court said (p. 290):

If the profit of 1913 had been distributed in that year, we think it would have been taxable, notwithstanding there was an operating deficit prior to March 1 of that year. * * *

In the *Hoffman* case the court was primarily concerned with the manner of computing what distributions had been made out of increases in value of property accrued prior to March 1, 1913, and the problem concerning the effect of the pre-1913 deficit was not dealt with as a specific issue.

In *Chapman v. Anderson*, 11 F. Supp. 913 (S.D. N.Y.), the court, also without discussing the point, indulged in the opposite assumption, namely, that a pre-1913 deficit is required to be absorbed by subsequent earnings before there can be accumulated earnings and profits available for dividend purposes. The *Chapman* case focused entirely on the question whether the write-up on the corporate books in 1925 of the value of the corporate assets as of March 1, 1913, was suffi-

wrong. In response to a request for information by the Department of Justice on this matter, the Chief Counsel, Bureau of Internal Revenue, by letter dated December 12, 1950, stated that "it has been the long-standing practice of the Bureau to not require that a pre-1913 deficit be eliminated before there can be earnings and profits available for dividends."

While the present cases apparently involve the first time that taxpayers have controverted the Commissioner on this precise point, the absence of prior litigation does not mean that the Commissioner has lately shifted position. The contrary is true.

cient to eliminate the March 1, 1913, deficit. That the court entirely missed the significance of what it was deciding, *sub silentio*, is evident from the fact that it relied on *Hadden v. Commissioner, supra*, which, as we have seen, applied the statute in a contrary manner. While the Tax Court thought that the *Chapman* case was (R. 80) "directly in point," the decision there, for the reason just stated, cannot be considered as persuasive authority in support of the Tax Court's decision.

In view of the foregoing, we submit that there is no rational basis for the tax exemption which the Tax Court has read into the statute. Since, on the contrary, there are compelling reasons to support the Commissioner's contention that the statute means what it says in defining a dividend in relation to earnings or profits accumulated after February 28, 1913, so that such accumulations would not be affected by the existence of a corporate deficit on that date, the construction of the statute adopted by the Tax Court should be rejected.

CONCLUSION

The decisions of the Tax Court should be reversed.

Respectfully submitted,

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FEBRUARY, 1951.

APPENDIX

INTERNAL REVENUE CODE:

SEC. 22. GROSS INCOME.

(a) *General Definition*.—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(26 U. S. C. 1940 ed., Sec. 22.)

(Sec. 22 (a) of the Revenue Acts of 1938, c. 289, 52 Stat. 447; 1936, c. 690, 49 Stat. 1648; Sec. 213 (a) of the Revenue Acts of 1926, c. 27, 44 Stat. 9; and 1918, c. 18, 40 Stat. 1057, and Sec. 2 (a) of the Revenue Act of 1916, c. 463, 39 Stat. 756, as amended by Sec. 1200 of the Revenue Act of 1917, c. 63, 40 Stat. 300, contain provisions which, as they relate to the issue of this case, are substantially similar to the above quoted portion of Sec. 22 (a) of the Internal Revenue Code.)

Revenue Act of 1916, c. 463, 39 Stat. 756:

Sec. 2. (a) That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from in-

terest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever: *Provided*, That the term "dividends" as used in this title shall be held to mean any distribution made or ordered to be made by a corporation, joint-stock company, association, or insurance company, out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation, joint-stock company, association, or insurance company, which stock dividend shall be considered income, to the amount of its cash value.

* * * * *

INTERNAL REVENUE CODE:

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend*.—The term "dividend" when used in this chapter (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions*.—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free

distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

* * * * *

(26 U. S. C. 1940 ed., Sec. 115.)

(Sec. 115 (a) and (b), Revenue Acts of 1938 and 1936 are identical. Sec. 201 (b), Revenue Acts of 1926, 1918, and Sec. 31 (b), Revenue Act of 1916, as added by Sec. 1211, Revenue Act of 1917, are, as they relate to the issue of this case, substantially similar to Section 115 (b), Internal Revenue Code.)

Revenue Act of 1926, c. 27, 44 Stat. 9:

Sec. 201. (a) The term "dividend" when used in this title (except in paragraph (9) of subdivision (a) of section 234 and paragraph (4) of subdivision (a) of section 245) means any distribution made by a corporation to its shareholders, whether in money or in other property, out of its earnings or profits accumulated after February 28, 1913.

* * * * *

(Secs. 201 (a), Revenue Act of 1918, and 31 (a), Revenue Act of 1916, as added by Sec. 1211, Revenue Act of 1917, as they relate to the issue of this case, are substantially similar to Section 201 (a), Revenue Act of 1926, quoted above.)

No. 12,664

IN THE
United States
Court of Appeals

For the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

VS.

GRACE H. KELHAM, LEILA H. NEILL, ELLIS
M. MOORE, HARRIET H. BELCHER, AND
LILLIE S. WEGEFORTH,
Respondents.

Brief on Behalf of Adolph B. Spreckels and Dorothy C. Spreckels, Taxpayers and Respondents in *Commissioner of Internal Revenue, Petitioner v. Adolph B. Spreckels, et al., Respondents*, No. 12,663.

On Petitions for Review of the Decisions of the
Tax Court of the United States

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On Petitions for Review of the Decisions of the
Tax Court of the United States

PRELIMINARY STATEMENT

This brief is submitted on behalf of Adolph B. Spreckels and Dorothy C. Spreckels (hereinafter referred to as “the taxpayers”), taxpayers and respondents in *Commissioner of Internal Revenue v. Adolph B. Spreckels, Dorothy C. Spreckels, Spreckels-Rosekrans Investment Company, John N. Rosekrans and Alma Spreckels Rosekrans*, No. 12,663

in this Court, on petition for review of the decisions of the Tax Court of the United States in *Adolph B. Spreckels, et al. v. Commissioner of Internal Revenue*, Tax Court Docket Nos. 5628, 5629, 5677 and 5678, reported at 13 T. C. 1079.

Taxpayers were stockholders in the J. D. and A. B. Spreckels Company (referred to in petitioner's brief and hereafter as "Spreckels Company") during the years 1938, 1939 and 1940, as were respondents Kelham, et al., in this case, and the question presented to this Court on review is identical in each case.

Pursuant to stipulation entered into between counsel and approved by this Court on October 25, 1950, it was stipulated that the *Spreckels'* case (No. 12,663) should be held in abeyance pending a final decision in this case, whereupon either party might apply to this Court for a judgment in conformity therewith. It was then further stipulated that counsel for any of the taxpayers and respondents in the *Spreckels'* case should have the privilege of filing a brief on their behalf in this case, and this brief is submitted accordingly.

JURISDICTION

The statement of pleadings and facts upon which the Commissioner relies to establish the jurisdiction of this Court to review the decisions of the Tax Court is uncontroverted. Brief for Petitioner, pp. 1-2.

STATEMENT OF THE CASE

The statement of facts presented by the Commissioner in his opening brief is uncontroverted, and is adopted for the purpose of this brief. Brief for Petitioner, p. 3.

The sole question before this Court is whether, in the case of a corporation having an operating deficit as of February 28, 1913, earnings of the corporation subsequent to that date are available for distribution as taxable dividends, or must first be applied to offset and eradicate the deficit before being deemed "earnings or profits accumulated after February 28, 1913," within the meaning of Section 115(a)(1) of the Internal Revenue Code.

The Tax Court decided that such an operating deficit must first be restored out of subsequent earnings before an accumulation of such earnings can be deemed to exist as a source of taxable dividends.

SUMMARY OF ARGUMENT

It is well established that a corporation which incurs an operating deficit *after* February 28, 1913, can have no accumulation of earnings or profits for distribution as a taxable dividend within the meaning of Section 115(a)(1) of the Internal Revenue Code until this impairment of capital has been removed. This rule was established without express statutory provision in recognition of the general principle that a corporation cannot have earnings available for dividends while its capital stands impaired by losses. The reason behind this rule as to post-1913* deficits applies with equal force to deficits incurred at any time during the existence of a corporation, and it is completely illogical to apply a different rule to pre-1913 deficits, unless Congress has indicated an intent to draw an arbitrary line at February 28, 1913, for all purposes.

*The terms "post-1913" or "pre-1913" will be used hereafter to refer to events or conditions existing after February 28, 1913, or before March 1, 1913, respectively.

From an examination of the legislative history behind Section 115, it appears that the phrase "earnings or profits accumulated after February 28, 1913," was introduced into the definition of a "dividend" for the purpose of allowing a tax free distribution of earnings and profits accumulated before the effective date of the first income tax law. The equivalent of Section 115(b) was added later to set up a presumption as to the source of dividends, and the complementary phrase "earnings or profits accumulated * * * before March 1, 1913," was introduced by way of spelling out the application of the presumption to such profits. These provisions do not indicate a congressional intent to freeze February 28, 1913, balance sheets for the purpose of computing operating deficits. On the contrary, the Supreme Court of the United States has directly refused for other purposes to erect such an arbitrary point of reference from the statutory use of the phrase "earnings or profits accumulated after February 28, 1913."

The holding of the Tax Court was, therefore, correct.

ARGUMENT

The Tax Court held that an operating deficit existing on February 28, 1913, must be restored from subsequent earnings before a corporation has "earnings and profits accumulated since February 28, 1913," for distribution as taxable dividends. The taxpayers are in complete agreement with the carefully reasoned majority opinion of that Court by Judge Turner. Principal attention will, therefore, be given to the arguments advanced by the Commissioner in his opening brief.

The Commissioner makes three principal arguments: (1) That the Tax Court's construction is untenable because it

creates an *exemption* by unwarranted implication (Brief for Petitioner, pp. 15-21); (2) that neither the general corporate principles nor the cases involving post-1913 deficits relied on by the Tax Court have any bearing on the instant problem (Brief for Petitioner, pp. 21-28); and (3) that the Tax Court has misconstrued Section 115(a)(1) in that the effect of its holding is to treat the phrase "earnings or profits accumulated after February 28, 1913," as surplusage without meaning or effect (Brief for Petitioner, pp. 11-15). These arguments are listed in the order in which they will be considered in this brief, rather than the order in which they are set out in the Commissioner's brief.

A. The Cases Requiring Restoration of Post-1913 Operating Deficits Give Judicial Recognition for Tax Purposes to a Principle Which Is Equally Applicable to Pre-1913 Operating Deficits.

It appears that the issue of this case has never before been squarely presented to a court for decision.* In construing the definition of "dividends" in Section 115(a)(1)

*In *Chapman v. Anderson*, 11 F. Supp. 913 (S.D. N.Y. 1935), the Court held that certain corporate distributions were non-taxable because an operating deficit existing on March 1, 1913, had not been restored; but neither party disputed the necessity for restoring the deficit. In *Hadden v. Commissioner*, 49 F.2d 709 (C.C.A. 2d 1931), the Court held corporate distributions non-taxable to the extent that net operating losses after March 1, 1913, had not been restored; but, with the acquiescence of both parties, and without any discussion of the point, the Court gave no effect to the corporation's operating deficit on March 1, 1913. *Hoffman v. United States*, 53 F.2d 282 (Ct. Cls. 1931), involved a pre-1913 deficit, but was decided on the erroneous premise that any deficit could be ignored if the distribution was out of earnings of the current year. This premise has clearly been overruled; see cases cited in text, *infra*, page 6. *J. L. Washburn*, 16 B.T.A. 1091 (1929), required restoration of a deficit, a portion of which was apparently incurred between 1907 and March 1, 1913, but no consideration was given to any possible distinction between pre-1913 and post-1913 operating losses.

it is, therefore, appropriate to consider how the definition has been applied in other instances. The Tax Court did this, and its holding is a logical and necessary extension of a well-settled rule.

Both the Commissioner and the dissenting judges in the Tax Court admit that a corporation which incurs an operating deficit *after* March 1, 1913, can have no accumulation of earnings or profits within the meaning of Section 115(a)(1) of the Internal Revenue Code until the impairment of capital has been restored by subsequent earnings. R. 104; Brief for Petitioner 24. Numerous cases have so held. *E.g.*, *Foley Securities Corp. v. Commissioner*, 106 F.2d 731 (C.C.A. 8th 1939); *Louise Glaswell Shorb*, 22 B.T.A. 644 (1931); *J. L. Washburn*, 16 B.T.A. 1091 (1929); *cf. Willcuts v. Milton Dairy Co.*, 275 U.S. 215 (1927); *see, also* G. C. M. 1552, VI-1 C.B. 10 (1927); L.O. 942, 1 C.B. 300, 301 (1919).

Two things are particularly significant about this rule regarding the restoration of post-1913 operating deficits: (1) It was established without the aid of any express statutory exemption, and (2) it is a recognition and application of a fundamental principle of corporation law, namely, that dividends paid in the face of an operating deficit are a return of capital.

As stated by the Board of Tax Appeals in *Loren D. Sale*, 35 B.T.A. 938 (1937), at page 941:

“The statute* does not provide that impaired capital or paid-in surplus must be restored before earnings are available for the distribution of a taxable dividend.

*The case involved Section 201 of the Revenue Act of 1924, which contained provisions substantially similar to Sections 115(a)(1) and 115(b) of the Internal Revenue Code.

That rule of law was laid down by the Board and the courts, which had in mind the fundamental principle that a corporation, the capital of which had been impaired by losses, can never have any accumulated earnings until its capital is restored. Corporations, of course, were well known long before March 1, 1913, the effective date of the income tax. Likewise, the concepts of capital and impairment of capital were fixed in the law and generally understood. The provisions of the revenue acts have not changed the law in respect of capital or impairment of capital. * * *"

To the same effect is a Memorandum of the General Counsel of the Bureau of Internal Revenue:

"The term 'dividend' is defined by Section 201(a) of the Revenue Act of 1926* as any distribution made by a corporation to its shareholders, whether in money or in other property, out of its earnings or profits accumulated after February 28, 1913. Although it is provided in section 201(b) that for the purposes of the Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits, there can be no accumulation of profits until an operating deficit is made good. *As there was no surplus from which a dividend could have been paid, it necessarily follows that the distribution must have been out of capital.*" (Emphasis added) G.C.M. 1552, VI-1 C.B. 10 (1927).

The very existence of this uncontroverted rule as to post-1913 operating deficits indicates the fallacy of two of the Commissioner's arguments:

*Sections 201(a, b) of the Revenue Act of 1926 contained provisions substantially similar to Sections 115(a)(1) and 115(b) of the Internal Revenue Code.

(1) The Commissioner contends that the Tax Court's construction of Section 115(a)(1) creates an *exemption* by implication. This, he urges, violates the rule that exemptions may not rest on implication and is contrary to the congressional policy of taxing all distributions of post-1913 earnings and profits. Brief for Petitioner, pp. 15-21.

It is apparent that if the holding of the present Tax Court creates an exemption, the rule as to post-1913 deficits must also be regarded as creating an exemption.* The validity of this argument of the Commissioner may, therefore, be determined by applying it to the rule as to post-1913 deficits. As noted, this rule of law, requiring post-1913 operating deficits to be restored before a distribution is considered to be out of accumulated earnings and profits, was established without the aid of an express statutory exemption. How is it that the line of reasoning indulged in by the Commissioner did not prevent this rule from arising? The obvious answer is that neither this rule nor the rule adopted by the Tax Court as to pre-1913 deficits *exempts* dividends from earnings accumulated after March 1, 1913, from taxation. Both rules (which are really but one) simply recog-

*This may be illustrated by the following situations: (1) Corporation A was organized in 1914, had an operating deficit of \$10,000 by the end of 1914, broke even each year thereafter until 1920, had net profits of \$10,000 in 1920, and at the end of 1920 made a distribution of \$10,000 to its stockholders. (2) Corporation B was organized in 1912, had an operating deficit of \$10,000 on February 28, 1913, broke even each year thereafter until 1920, had net profits of \$10,000 in 1920, and at the end of 1920 made a distribution of \$10,000 to its stockholders.

It is well settled that the distribution of Corporation A would *not* have been a taxable dividend. Correspondingly, the Tax Court below held that the distribution of Corporation B would *not* have been a taxable dividend. Each corporation realized earnings after 1913 equal to the amount of its distribution. If it is an "exemption" to hold either distribution non-taxable, it is equally an "exemption" to hold the other non-taxable.

nize that a distribution while capital is impaired as a result of operating losses is in reality a return of capital, and not ordinary taxable income at all. No "exemption" is involved.

It should be noted that in making this argument the Commissioner repeatedly cited the case of *Helvering v. Canfield*, 291 U.S. 163 (1934). Brief for Petitioner, pp. 15, 16, 17, 18, 19. The Commissioner relies on statements in that case indicating that the exemption as to pre-1913 earnings in the statute* is to be strictly construed to effectuate the congressional plan to prevent profits accumulated after that date from escaping taxation. This reliance is seriously misplaced.

The *Canfield* case involved a corporation with a *surplus* on February 28, 1913, operating losses for the years 1915 and 1916, and net earnings for years subsequent to 1916. The Supreme Court held that the operating losses should be charged against the surplus (which exceeded the total of the losses) and did not have the effect of reducing profits earned thereafter, and accordingly found certain distributions in 1923 to be taxable in full.

The Court itself was careful to point out the very reasons why the statements relied on are not at all in point with respect to the instant case. Thus, the Court said (p. 167):

"The argument that the surplus of March 1, 1913, constituted capital is unavailing. We are not here concerned with capital in the sense of fixed or paid-in capital, which is not to be impaired, or with the restoration of such capital where there has been impairment. *No case of impairment of capital is presented.*

*The case involved Sections 201(a, b) of the Revenue Act of 1921 which contained provisions substantially similar to Sections 115(a)(1) and 115(b) of the Internal Revenue Code.

We are dealing with a distribution of accumulated profits.” (Emphasis added)

And again at the end of the same paragraph (p. 167):

“There is no question here of the receipt of ‘capital.’ ”

The Court was clearly conscious of the very distinction which dooms the Commissioner’s argument that the Tax Court below created an exemption by implication. The *Canfield* case, as noted by the Court, did *not* involve an impairment of capital* and therefore raised no question of a return of capital. Exactly the opposite is true of the instant case. The *Canfield* case was dealing with the *exemption* as to a pre-1913 surplus. This was a matter of legislative grace† and properly called for strict construction. By way of contrast, the instant case turns not on an exemption but on the fundamental concept that a return of capital is not a taxable dividend. The language quoted (*supra*, pp. 9-10), indicates that the Supreme Court would have reached a contrary result if impairment of capital rather than pre-1913 surplus had been involved.

The *Canfield* case not only fails to support the Commissioner’s argument—it clearly demonstrates the error therein.

(2) The Commissioner also argues that neither general corporation principles nor cases involving post-1913 deficits are helpful in deciding the instant case. Brief for Petitioner, pp. 21-25.

*As will be discussed in Part B of the Argument, *infra*, pp. 16-17, in finding that no case of impairment of capital was involved, the Court in the *Canfield* case looked to the accounting period from the time of the corporation’s inception and thereby *also* undermined the Commissioner’s argument that March 1, 1913 has been established as a dividing line fixing the state of a corporation’s capital for tax purposes.

†See *Lynch v. Hornby*, 247 U.S. 339 (1918).

It may be admitted that the congressional definition of a dividend does not necessarily conform to general corporation law. However, in the situation most closely analogous to that of the instant case, i.e., in the case of post-1913 operating deficits, the fundamental principles of corporate law as to when a distribution represents a return of capital have been recognized and applied, in the absence of an express statutory declaration. In the light of this fact, it can scarcely be correct, as suggested by the Commissioner (Brief for Petitioner, pp. 21-22), that it "carries not the slightest weight of persuasion" that his contention is plainly contrary to fundamental principles of corporation law.

The general principle recognized by the rule as to post-1913 deficits is that a distribution while capital is impaired by operating losses is a return of capital. Capital is as much impaired by pre-1913 operating deficits which have not been restored as by post-1913 deficits. In short, the principle behind the settled rule as to post-1913 deficits applies with equal force to pre-1913 deficits; the authorities establishing the former rule should be regarded as controlling unless a congressional intent to draw an arbitrary line at February 28, 1913 for this purpose can be found.

B. There Is No Basis in the Statute for a Distinction Between the Impairment of Capital After February 28, 1913, and the Identical Impairment Before That Date.

The holding of the Tax Court accords the same effect to operating deficits whether incurred before or after March 1, 1913. The only argument advanced by the Commissioner for a *distinction* in the treatment of post-1913 operating deficits and pre-1913 deficits is that the phrase

“earnings or profits accumulated after February 28, 1913” in Section 115(a)(1) of the Internal Revenue Code would otherwise be completely superfluous and without meaning. Brief for Petitioner, pp. 11-15.

Section 115 of the Internal Revenue Code contains the following provisions:

“DISTRIBUTIONS BY CORPORATIONS.

“(a) *Definition of Dividend*.—The term ‘dividend’ * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or, (2) out of the earnings or profits of the taxable year * * * without regard to the amount of the earnings and profits at the time the distribution was made.*

“(b) *Source of Distributions*.—For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against, and reduce the adjusted basis of the stock provided in Section 113.”

The Commissioner seems to argue that Section 115(b) is the operative provision to protect pre-1913 earnings from being taxed when distributed; that the phrase “accumulated after February 28, 1913” in Section 115(a)(1) does not serve this purpose; and that this phrase therefore has no meaning unless the construction adopted by the

*See footnote †, *infra*, p. 14.

Tax Court is rejected. It is submitted that the argument is without merit.

Subdivision (a) defines the term "dividend" for tax purposes. As an expression of the congressional purpose to allow tax-free distribution of any pre-1913 surplus, the definition includes only distributions out of earnings or profits accumulated after February 28, 1913. Subdivision (b) sets up presumptions as to the source of corporate distributions. The second sentence of subdivision (b) is merely an application of the general presumption to the specific case of pre-1913 earnings, i.e., they may be distributed tax-free only after all post-1913 earnings have been distributed.

The error of the Commissioner's contention is further emphasized by the legislative history behind these provisions. The first income tax law, the Revenue Act of 1913 (33 Stat. 166), provided that "net income * * * shall include gains, profits, and income derived from * * * dividends * * *" but contained no definition of dividends. Accordingly, the Treasury Department adopted the practice of treating dividends received by stockholders after February 28, 1913 as fully taxable even though entirely out of earnings of a corporation prior to that date.

Doubt as to the constitutionality and justness of this practice induced Congress to include the following provision in the Revenue Act of 1916 (39 Stat. 756):

*"Provided, that the term 'dividends' as used in this title shall be held to mean any distribution made * * * by a corporation * * * out of its earnings or profits accrued since March first, nineteen hundred and thirteen, * * *"*

This definition has been continued in substantially identical form down to the present definition in Section 115 (a) (1) of the Internal Revenue Code. The congressional purpose in adding this definition was clearly to allow the tax-free distribution of pre-1913 earnings and profits. As expressed by the Board of Tax Appeals in *M. H. Alworth Trust*, 46 B.T.A. 1045 (1942),* at page 1047:

“* * * In acts prior to the Revenue Act of 1936,† the term ‘dividend’ was defined as ‘any distribution made by a corporation to its shareholders, whether in money or other property, out of its earnings or profits accumulated after February 28, 1913.’ *Certainly there is nothing in the definition to indicate that Congress had in mind any limitation or change in the commonly accepted meaning of the term ‘dividend,’ except to exclude distributions from earnings or profits accumulated prior to February 28, 1913.*

* * *” (Emphasis added)

Under the 1916 Act, the source of a distribution (i.e., whether from earnings accumulated before or after March 1, 1913) was apparently determined in accordance with the designation of the payment by the corporation. To change this, Congress, in 1917, added a conclusive presumption as to the source of corporate distributions.‡

*Reversed on other grounds, *Helvering v. Alworth Trust*, 136 F.2d 812 (C.C.A. 8th 1943).

†Section 115(a)(2) was added to the definition by the Revenue Act of 1936. By this subsection (quoted in part, *supra*, p. 12) a distribution out of earnings or profits of the taxable year is a taxable dividend *without regard to the amount of the earnings and profits at the time the distribution was made*. Application of this subsection is not involved under the facts in the instant case.

‡For discussion of the reasons leading to the changes of the 1916 and 1917 Acts, see *Edwards v. Douglas*, 269 U.S. 204, 211-213 (1925).

The definition of a "dividend" from the 1916 Act was repeated substantially word for word as subdivision (a) of Section 31 of the Revenue Act of 1917 (40 Stat. 300), and subdivision (b) was added, containing the following provisions:

"Any distribution * * * in the year nineteen hundred and seventeen, or subsequent tax years, shall be deemed to have been made from the most recently accumulated undivided profits or surplus, and shall constitute a part of the annual income of the distributee for the year in which received, * * * but nothing herein shall be construed as taxing any earnings or profits accrued prior to March first, nineteen hundred and thirteen, but such earnings or profits may be distributed * * * after the distribution of earnings and profits accrued since March first, nineteen hundred and thirteen, has been made. * * *"

The two subdivisions of Section 31, insofar as they relate to the instant case, have been continued in substantially the same form down to the present and are now Sections 115(a)(1) and 115(b) of the Internal Revenue Code.

From the foregoing it is apparent that the phrase "earnings or profits accumulated after February 28, 1913" was inserted in the definition of "dividends" as the operative provision to exempt pre-1913 earnings from taxation. The holding of the Tax Court in no way ignores or interferes with this intended meaning and effect; it simply declines to imply an effect never intended. The reference to "earnings or profits accumulated * * * before March 1, 1913," in subdivision (b) was added later and is merely a complementary provision employed in spelling out the application of the presumption to pre-1913 earnings.

The focus on March 1, 1913 does not indicate an intent to draw a line at this date as to the existing state of corporate capital. The statutory contrast between distributions out of earnings accumulated before 1913 and those accumulated after 1913 is not at all left meaningless by the Tax Court's holding; the former are non-taxable distributions, the latter are taxable "dividends."

The error of the Commissioner's position in this respect is also demonstrated by *Helvering v. Canfield*, 247 U.S. 339 (1934), previously discussed (*supra*, pp. 9-10). The Commissioner seeks to measure the existence or non-existence of corporate earnings or profits for the purpose of taxable distributions by operations from March 1, 1913 only, rather than over the life of the corporation. If this were correct, a corporation with net losses since February 28, 1913 would come within the rule requiring restoration of post-1913 operating deficits and a surplus or deficit existing on March 1, 1913 would not affect the calculation. The same argument was advanced by the taxpayers in the *Canfield* case and rejected by the Supreme Court. In that case the corporation had net operating losses from March 1, 1913 to the end of 1917, yet the Court refused to apply subsequent earnings to restore the deficit *computed over this period*. Instead, the Court said that no case of impairment of capital was presented,* i.e., it looked to the life of the corporation and found no operating deficit because of the pre-1913 surplus. It cannot logically be contended that the existence or non-existence of a deficit should be computed over a lesser period simply because pre-1913 operations resulted in a net loss. A distribution while capital is impaired (which must be computed over

*See quotation from opinion, *supra*, p. 9.

the life of the corporation) is not out of earnings or profits, but is a return of capital.

CONCLUSION

The decisions of the Tax Court should be affirmed.

Respectfully submitted,

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Dated: March 2, 1951

No. 12,664

IN THE
United States Court of Appeals
For the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

GRACE H. KELHAM, LEILA H. NEILL, ELLIS
M. MOORE, HARRIET H. BELCHER, and
LILLIE S. WEGEFORTH,
Respondents.

On Petitions for Review of the Decisions of the Tax Court
of the United States.

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Respondents.

On Petitions for Review of the Decisions of the Tax Court
of the United States.

BRIEF FOR RESPONDENTS.

OPINION BELOW.

The opinion of the Tax Court (R. 64-98) together with the concurring opinion (R. 98-101), which represented the views of twelve judges, and the dissenting opinion (R. 102-117), in which three of the judges concurred, are reported at 13 T. C. 984.

JURISDICTION.

These consolidated cases involve asserted deficiencies in individual income taxes for the calendar years 1937-1940, inclusive, or for some of those years in the case of some of the taxpayers. Taxpayers' income tax returns for the years in question were filed in the First and Sixth Districts of California. Notices of deficiencies were mailed to the taxpayers on April 22, 1944 (R. 197-200), May 13, 1944 (R. 220-228), and on May 26, 1944 (R. 13-17, 134-141, 169-178). Petitions for redetermination by the Tax Court of the United States were filed by the taxpayers, pursuant to the provisions of section 272 of the Internal Revenue Code, on June 12, 1944 (R. 6-17, 122-141), July 5, 1944 (R. 155-178), and July 17, 1944 (R. 192-200, 209-228). The decisions of the Tax Court were entered on March 14, 1950 (R. 118, 150-151, 187-188, 205, 236). The Commissioner filed petitions for review by this Court on June 2, 1950 (R. 119-121, 152-155, 189-192, 206-208, 237-240). The jurisdiction of this Court rests on section 1141 (a), Internal Revenue Code, as amended by section 36 of the Act of June 25, 1948.

QUESTION PRESENTED.

Section 115 (a) (1), Internal Revenue Code, defines a dividend as a distribution by a corporation out of its earnings or profits accumulated after February 28, 1913. The question presented is whether the Tax Court was correct in construing this section of the statute to mean that a corporation can have no accumulated earnings or profits available for taxable dividends until an operating

deficit existing on March 1, 1913 has been restored by subsequent earnings.

STATUTES INVOLVED.

These cases involve the construction of the following portion of section 115 (a) of the Internal Revenue Code:

“(a) Definition of Dividend.—The term ‘dividend’ when used in this chapter * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913 * * *.”

The applicable provisions of other relevant statutes not set forth in the body of the brief will be found in the Appendix, *infra*.

SUMMARY OF ARGUMENT.

A. Preliminary statement.

B. The Tax Court correctly decided that an operating deficit as of March 1, 1913 must be restored before there are accumulated earnings or profits available for dividends.

1. It is fundamental that there can be no earnings available for dividends while capital is impaired.

2. The Treasury Department follows the general rule.

3. The basis of the government's contention was repudiated by the Supreme Court in the *Canfield* case.

4. The only authorities on the point are contrary to the government's position.

5. Comparison of provisions of earlier statutes shows conclusively that all operating deficits must be restored before earnings or profits are available for dividends.

6. The addition in 1936 of Part (2) of the definition of a dividend does not change the meaning of Part (1).

C. The government's construction raises the question of constitutionality of this section as applied to the facts of this case.

D. Correction of miscellaneous arguments in government's brief.

1. This case does not involve a claim for exemption from tax.

2. The Tax Court's decision does not render any words in the statute meaningless.

3. Government's quotation from *Foster* case is misleading.

E. The cases primarily relied upon by the government are not in point.

A. PRELIMINARY STATEMENT.

The question involved which is determinative of these cases is whether the earnings or profits of J. D. and A. B. Spreckels Company available for dividends were increased by approximately \$5,000,000 as a result of the liquidation

of Oceanic Steamship Company, a wholly-owned subsidiary, in 1936. During its early years Oceanic sustained very heavy operating losses but it was more successful in later years and finally at the time of its liquidation in 1936 it had succeeded in making up the early losses so that it had a small earned surplus. It is admitted that this earned surplus was transferred to the Spreckels Company upon the liquidation of Oceanic under the theory of the *Sansome* case (60 F. 2d 931) and became available for dividends by that company. However, the government contends that as a result of the liquidation of Oceanic the earnings and profits of the Spreckels Company available for dividends were increased by an amount exceeding \$5,000,000. It arrived at this amount by taking into account the earnings of Oceanic since March 1, 1913 and entirely ignoring the fact that prior to March 1, 1913 Oceanic sustained operating losses in the amount of \$4,878,987.40.

The economic fallacy of this position can be illustrated by a simple example: Assume that Oceanic had been incorporated for \$10,000,000 as a wholly-owned subsidiary of the Spreckels Company, that prior to March 1, 1913 it had lost \$5,000,000, and that thereafter it had earned \$5,000,000 and had then liquidated, never having paid a dividend. It is apparent that the Spreckels Company would have broken even in this venture having sustained neither gain nor loss. To argue that its earnings or profits available for dividends were increased by \$5,000,000 is therefore an economic absurdity. If it had sold the stock in 1936 for \$10,000,000 instead of liquidating, its earnings

or profits would not have been increased since no gain or loss would have been realized. The fact that the March 1, 1913 value of the stock of Oceanic would in such case have been \$5,000,000 does not alter this conclusion since section 115 (1) of the Internal Revenue Code (expressly made applicable by section 501 (b) and (c) of the Revenue Act of 1940 to all prior taxable years) provides that for the purpose of the computation of earnings and profits of a corporation gain or loss realized from the sale or other disposition of property shall be determined by using the basis for determining *gain*, which in such case would be the original cost (section 113 (a) (14)). Thus, under the facts supposed above, if the Spreckels Company had sold the stock of Oceanic in 1936 to Matson for \$10,000,000, no gain or loss would have been realized and its earnings or profits available for dividends would have been unaffected. If, however, it had liquidated Oceanic and then sold its assets for \$10,000,000 to Matson, then no gain or loss would have been realized, but the government would have us believe that its earnings or profits available for dividends would be increased by \$5,000,000. The statute should not be construed to produce such an anomalous result unless such construction is unavoidable.

B. THE TAX COURT CORRECTLY DECIDED THAT AN OPERATING DEFICIT AS OF MARCH 1, 1913 MUST BE RESTORED BEFORE THERE ARE ACCUMULATED EARNINGS OR PROFITS AVAILABLE FOR DIVIDENDS.

The question presented depends upon the construction to be given to the following portion of section 115(a) of

the Revenue Act of 1938 and of the Internal Revenue Code:

“The term ‘dividend’ * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913 * * *.”

It is our position that there must be “earnings or profits” before there can be any “earnings or profits accumulated after February 28, 1913,” and that a corporation can have no earnings or profits available for dividends until an operating deficit, whether in existence on March 1, 1913, or arising later, has been restored. It is a contradiction in terms to say that a corporation has accumulated profits when its capital is impaired. The government’s position has been well summarized by the Tax Court in its opinion (R. 71) where it is stated that the government contends “that in computing corporate earnings accumulated after February 28, 1913, regard is to be given only to operating results after that date, and no regard is to be given to the condition or state of the corporate capital on that date.”

The words “accumulated after February 28, 1913” were first added to the statute in substantially the same form in the Revenue Act of 1916. The purpose Congress had in mind in adding these words to the statute is discussed in *Lynch v. Hornby*, 247 U. S. 339 (1918). In that case a company declared dividends of \$650,000 in 1914, of which \$240,000 was paid out of earnings since March 1, 1913, and \$410,000 from profits on sale of property held

on March 1, 1913. Hornby claimed that the latter portion, representing earnings accumulated prior to March 1, 1913, was free from tax. The court held that the entire dividend of \$650,000 was subject to tax. The word "dividend" was not defined in the Act of 1913, although specifically included under the definition of gross income, but the court relied upon its well understood meaning as a distribution from earnings and held that distributions from earnings accumulated prior to March 1, 1913 were included within the meaning of the term. In its opinion the court pointed out that the Revenue Act of 1916 added a provision for the purpose of excluding from the effect of the tax any dividends declared out of earnings or profits that accrued prior to March 1, 1913. This provision (section 2(a)) limited the words "earnings or profits" to "earnings or profits accrued since March first, nineteen hundred and thirteen." The court said that it regarded the change "as a concession to the equity of stockholders granted in the 1916 Act, in view of constitutional questions that had been raised" in the *Hornby* and other cases.

1. It is fundamental that there can be no earnings available for dividends while capital is impaired.

The words "accrued since March first, nineteen hundred and thirteen" must be interpreted in the light of the "concession to the equity of stockholders" which prompted their addition. All that Congress intended was to exempt from the tax dividends from earnings accrued prior to March 1, 1913. There is nothing to indicate that an impairment of capital existing on March 1, 1913 is to be disregarded. The opinion of Judge Murdock in the case

of *Loren D. Sale*, 35 B. T. A. 938 (1937), contains an excellent statement of the necessity of restoring impaired capital before a corporation can have any accumulated earnings available for dividends. After first stating that (page 939)

“There is a rule of law that every impairment of capital or paid-in surplus resulting from operating losses must be restored before any earnings can be available for the distribution of a taxable dividend within the meaning of section 201(a) of the Revenue Act of 1924. * * *”

the opinion contains the following statement (page 941):

“The statute does not provide that impaired capital or paid-in surplus must be restored before earnings are available for the distribution of a taxable dividend. That rule of law was laid down by the Board and the courts, which had in mind *the fundamental principle that a corporation, the capital of which had been impaired by losses, can never have any accumulated earnings until its capital is restored. Corporations, of course, were well known long before March 1, 1913, the effective date of the income tax. Likewise, the concepts of capital and impairment of capital were fixed in the law and generally understood. The provisions of the revenue acts have not changed the law in respect of capital or impairment of capital.* * * *” (Italics added.)

And in its opinion in this case the Tax Court concluded (R. 85):

“From the above, we think it follows that there can be no accumulation of profits until impaired capital has been restored. There is a difference, we

think, between the realization currently of earnings and profits and the accumulation thereof. In other words, *there can be no accumulation of earnings where profits, as earned, are absorbed in restoration of capital which has been impaired through previous operating losses, and it seems to us fundamental that it matters not whether the impairment occurred before or after March 1, 1913. * * **” (Italics added.)

2. The Treasury Department follows the general rule.

The Treasury Department itself, in promulgating its official Regulations relating to the computation of invested capital for excess profits tax purposes under the Revenue Act of 1918 and the Revenue Act of 1921, stated in Article 838 of both Regulations 45 and Regulations 62:

“* * * In the computation of earned surplus and undivided profits recognition should first be given to all expenses incurred and losses sustained *from the original organization of the corporation down to the taxable year * * **. *There can, of course, be no earned surplus or undivided profits until any deficit or impairment of paid-in capital has been made good. * * **” (Italics added.)

In *Willcuts v. Milton Dairy Co.*, 275 U. S. 215, 218 (1927), the Supreme Court quotes the foregoing language from Article 838, and says:

“* * * But it is a prerequisite to the existence of ‘undivided profits’ as well as a ‘surplus,’ that the net assets of the corporation exceed the capital stock. Hence, where the capital is impaired, profits, though earned and remaining in the business, if insufficient to offset this impairment do not constitute ‘undivided profits.’ ”

It is true that this decision of the Supreme Court, as well as the Treasury Regulations just referred to, both deal with the determination of invested capital for excess profits tax purposes but, as stated by the Court of Appeals in *Hadden v. Commissioner*, 49 F.2d 709 (CA-2, 1931), "Congress did not intend that a corporation should be held to accumulate profits for one tax purpose only and not for another. * * *"

The identity between the determination of earnings or profits for invested capital purposes and for the purpose of determining the taxability of corporate distributions is illustrated by the decision in *Troy Record Co.*, 11 B. T. A. 298 (1928). One of the issues involved in this case was whether the Commissioner was correct in reducing invested capital by the amount of \$22,745.20 representing dividends paid in 1916, 1917, 1918 and 1919 which the Commissioner determined had been paid out of capital. The corporation, which operated a small newspaper, was organized and began publication in 1896. During the years 1896 to 1905, inclusive, it sustained operating losses. It first began to make money in 1906. The Commissioner determined that the 1896 to 1905 operating losses constituted an operating deficit which he further determined had not been completely restored at the time when dividends amounting to \$22,745.20 were paid during the years 1916 to 1919, inclusive. (There was therefore an operating deficit on March 1, 1913.) Accordingly, the Commissioner reduced invested capital by the amount of these dividends on the ground that they had been paid out of capital. The court approved the determination of the Commissioner for the reason that the taxpayer had not shown that the

operating deficit which had been incurred prior to 1906 had been eliminated at the time the dividends were paid. Thus in this case we see the government taking a position directly opposite to its position before this court and insisting that dividends declared before the elimination of a March 1, 1913 deficit by subsequent earnings are distributions of capital. If the dividends were distributions of capital for invested capital purposes they certainly cannot be simultaneously treated as distributions from earnings or profits taxable to the recipients. Nor do we believe that the government would have taken such an inconsistent position.* We believe that this case demonstrates that at least as late as this decision (1928) the government recognized that a March 1, 1913 deficit had to be restored before there could be any accumulated earnings or profits, regardless of the purpose for which the computation was made.

That this was true for income tax purposes as well as for invested capital purposes is shown by an income tax ruling made in 1927 by the General Counsel of the Bureau of Internal Revenue (G. C. M. 1552, VI-1 CB 10) in which he stated:

*See I. T. 3765, 1945-CB 270, where a corporation had an operating deficit during the years 1936 to 1943 and in each of the years made distributions in amounts not exceeding the current earnings of the respective years which were taxable as dividends. Section 718 (b) (1) of the Internal Revenue Code provides that invested capital must be reduced by distributions made *prior to the taxable year* which are not out of *accumulated earnings or profits*. Nevertheless, it was held that Congress did not intend "to tax distributions as being out of a corporation's earnings or profits and, at the same time, provide for a reduction of equity invested capital by the amount of such distributions as being out of capital."

“The term ‘dividend’ is defined by Section 201(a) of the Revenue Act of 1926 as any distribution made by a corporation to its shareholders, whether in money or in other property, out of its earnings or profits accumulated after February 28, 1913. Although it is provided in section 201(b) that for the purposes of the Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits, *there can be no accumulation of profits until an operating deficit is made good.* As there was no surplus from which a dividend could have been paid, it necessarily follows that the distribution must have been out of capital.” (Italics added.)

3. The basis of the government’s contention was repudiated by the Supreme Court in the Canfield case.

Fundamentally, the contention now advanced by the government involves the concept that a line is drawn on March 1, 1913 and that a new start is made on that date, everything on the other side of the line being ignored. From this the government concludes that, to determine earnings or profits accumulated since March 1, 1913, it is merely necessary to strike a balance of gains and losses since that date. This is the same contention that was advanced in *Helvering v. Canfield*, 291 U.S. 163 (1934). In that case the company had an earned surplus of \$4,332,684.78 on March 1, 1913. Its fiscal year ended on February 28, and for the year ending in 1914 it had a profit of \$4,594.62, for the year ending in 1915 a loss of \$193,139.67, for the year ending in 1916 a loss of \$211,707.32, and profits thereafter. The question involved was whether the losses of 1915 and 1916 reduced the earned

surplus as of March 1, 1913, or whether they should be carried forward and deducted from profits of years subsequent to 1916 in determining "earnings or profits accumulated since February 28, 1913." The taxpayer contended that for income tax purposes there were two distinct periods, (1) that period prior to March 1, 1913, and (2) that period after March 1, 1913, and that the accumulations for each period constituted "a fixed and static amount, not to be changed by the happenings after the end of the period." He accordingly concluded that the losses of 1915 and 1916 must be deducted from profits of subsequent years in ascertaining earnings accumulated since March 1, 1913. But the Supreme Court refused so to read the statute. The court held that the losses of 1915 and 1916 reduced the earned surplus existing on March 1, 1913 and did not have to be restored by subsequent profits. Thus the "earnings or profits accumulated since February 28, 1913" were determined to be greater than the balance of gains or losses since that date by the amount of the losses which were charged back to the earned surplus as of March 1, 1913. This case therefore conclusively establishes that the concept of the government in the instant case—namely, that it is merely necessary to strike a balance of post-1913 gains or losses in order to determine earnings accumulated since March 1, 1913—is fallacious.

If accumulated earnings as at March 1, 1913 still remain available to absorb subsequent operating losses, then it must certainly follow that an operating deficit as of March 1, 1913 likewise remains available to absorb subsequent

earnings. In order to hold that earned surplus as of March 1, 1913 remained available to absorb losses occurring after that date, the court in the *Canfield* case had to overcome the effect of the statutory provision (section 201(b), Act of 1921) that distributions of pre-1913 earnings may be made exempt from tax after post-1913 earnings have been distributed. But there is no corresponding difficulty in holding that an operating deficit as of March 1, 1913 remains available to absorb subsequent earnings. On the contrary, such a decision is compelled by the fact that to ignore the operating deficit is to tax as income that which in reality is a distribution of capital. That the court in the *Canfield* case would have recognized this impelling reason for reaching the conclusion that a March 1, 1913 operating deficit must be absorbed by subsequent earnings is indicated by the following statement made in answer to the argument that pre-1913 earnings, because of the statutory provision that they could be distributed free of tax, really constituted capital:

“The argument that the surplus of March 1, 1913, constituted capital is unavailing. We are not here concerned with capital in the sense of fixed or paid-in capital, *which is not to be impaired, or with the restoration of such capital where there has been impairment*. No case of impairment of capital is presented.” (Italics added.)

4. The only authorities on the point are contrary to the government's position.

The only case in which this question has been squarely decided is *Chapman v. Anderson*, 11 Fed. Supp. 913 (D.C. N.Y. 1935), but even there the government did not con-

tend that the operating deficit existing on March 1, 1913 did not have to be restored by subsequent earnings,* it merely contended that the deficit *had been eliminated* by unrealized appreciation. In that case a corporation had an operating deficit of \$957,235.15 on March 1, 1913. Subsequent to 1913 it had substantial earnings and it declared three dividends of \$80,000 each on March 2, 1925, July 15, 1925 and January 12, 1926. The plaintiff argued that as of the dates of the two dividends declared in 1925 the deficit as of March 1, 1913 had not yet been completely eliminated by subsequent earnings, and that it was not until the dividend of January 12, 1926 that the deficit as of March 1, 1913 had been completely eliminated, there being on that date a surplus of \$48,845.92. Accordingly, the plaintiff contended that of the three dividends totalling \$240,000 only \$48,845.92 was subject to tax. The government contended that appreciation in value of the corporation's assets as of March 1, 1913 in the amount of \$274,838.97 should be applied in reduction of the operating deficit of \$957,235.15, with the result that such operating deficit would have been eliminated by subsequent earnings prior to the dividend declared on March 2, 1925, and that therefore all three dividends were fully taxable. The court first considered the question as to whether the March 1, 1913 operating deficit had to be restored by subsequent earnings, since if it did not, it was immaterial whether the unrealized appreciation did

*It thus appears that "the long-standing practice of the Bureau to not require that a pre-1913 deficit be eliminated * * *" (Pet. Brief, note 5, p. 26) does not antedate the year 1935. Presumably it originated with the amendment to section 115(a) made in 1936, and discussed *infra*, p. 25 et seq.

or did not reduce the operating deficit. After quoting section 201(a) of the Act of 1926, defining the term "dividend" to mean distributions out of "earnings or profits accumulated after February 28, 1913", the court quotes section 201(d) as follows:

"(d) If any distribution (not in partial or complete liquidation) made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, *and is not out of earnings or profits*, then the amount of such distribution shall be applied against and reduce the basis of the stock * * *." (Italics added.)*

The court then came to the conclusion that the operating deficit must be restored, stating that

"It seems clear that, unless an operating deficit or impairment of capital has been made good out of subsequent earnings or profits, any distribution of (on) stock is not a 'dividend' under 26 U.S.C.A., paragraph 932, supra." (Italics added.)

Having concluded that the operating deficit as of March 1, 1913 must be restored by subsequent earnings before the corporation could have any accumulated earnings or profits available for dividends, the court considered the second question involved in the case and determined that the March 1, 1913 deficit did not have to be reduced by the unrealized appreciation as of March 1, 1913. Accordingly the court held that of the three dividends totalling

*The court does not comment upon this statutory provision but its significance is plain, viz., if a distribution is not out of earnings or profits it reduces the basis of the stock because it is a capital distribution. Hence there must be earnings or profits in order to have a taxable dividend.

\$240,000 only \$48,845.92 was subject to tax, this being the amount of earnings available after the elimination of the entire operating deficit as of March 1, 1913 by subsequent earnings. The court thus held squarely that the operating deficit as of March 1, 1913 had to be restored by subsequent earnings or profits before there were any *accumulated* earnings or profits available for dividends.*

In referring to *Chapman v. Anderson*, Randolph Paul in "Selected Studies in Federal Taxation, Second Series", states (page 177):

"* * * It was held therein that a write-up of assets in 1925 to reflect their true value as of March 1, 1913, did not constitute 'earnings or profits' *which could be applied to reduce a March 1, 1913, operating deficit so as to render a subsequent distribution taxable as having been made from surplus.*

It cannot be said too often that the question we are discussing is what the statute means, not what Congress might have provided. It might perhaps have provided that a distribution of anything *other than contributed capital* was a dividend. A much more circumscribed purpose appears." (Italics added.)

Again, on page 166:

"It may be * * * it would be constitutional, as intimated in the Cummings case, to treat as dividends all corporate distributions *except distributions of capital contributed by the stockholders.*" (Italics added.)

*It seems clear that the government is in error in asserting (Pet. Brief, p. 28) that "the court entirely missed the significance of what it was deciding, *sub silentio* * * *."

The following statement appears in Mertens "Law of Federal Income Taxation", paragraph 9.30, Volume I, page 463:

"An impairment of capital by an operating deficit accumulated prior to March 1, 1913, must be made good, however, out of subsequent earnings. It is immaterial that although an operating deficit existed at March 1, 1913, the corporation had substantial unrealized increase in value of its properties on that date." (Italics added.)

Paragraph 9.30 of Mertens, in which the foregoing quotation appears, is cited as an authority by the Supreme Court in *Commissioner v. Phipps*, 336 U.S. 410 (1949). In that case the Supreme Court made the following statement (p. 418):

" * * Briefly stated, in the case of a distribution to a corporation with a deficit for either current or prior losses, the corporation receiving the distribution has no * * * earnings or profits available for current distribution until current income exceeds current losses, and no accumulated earnings or profits until its actual deficit from prior losses is erased. See 1 Mertens, Law of Federal Income Taxation, Paragraph 9.30, and cases cited therein, n. 44 et seq. * * *"* (Italics added.)

5. Comparison of provisions of earlier statutes shows conclusively that all operating deficits must be restored before earnings or profits are available for dividends.

The following statutory analysis will conclusively demonstrate the correctness of our contention that an operating deficit as of March 1, 1913 must be restored by sub-

sequent earnings before there are any accumulated earnings or profits available for dividends. In the case of *Chapman v. Anderson, supra*, it will be noted that the court quoted section 201(d) of the Act of 1926, which provides that if a distribution by a corporation is not out of increase in value of property accrued before March 1, 1913 *and is not out of earnings or profits*, then the amount of such distribution shall be applied against and reduce the basis of the stock. This section of the 1926 Act is identically the same as section 201(d) of the Act of 1924. The Congressional Committee reports on the Revenue Bill of 1924 of both the House and the Senate contain the following explanation of this provision (reprinted in 1939-1 (Part 2) C. B. 250, 274):

“This subdivision provides that amounts distributed by a corporation *which do not constitute distributions of earnings or profits* or increase in value of property accrued prior to March 1, 1913 (such as distributions out of unrealized appreciation in value of property or out of depreciation or depletion reserves) *constitute a return of capital* to the stockholders and are taxable to him only if, as, and to the extent that they exceed the basis of his stock.” (Italics added.)

It is apparent from section 201(d) of the 1924 Act and the Congressional explanation thereof that a distribution which is not a distribution of earnings or profits, or increase in value of property accrued prior to March 1, 1913, is a capital distribution which is taxable only if, as, and to the extent that it exceeds the basis of the

stockholder's stock.* Therefore a distribution which is not a distribution of earnings or profits cannot be taxed as a dividend.

In order to answer the foregoing argument the government must of necessity contend that the words "earnings or profits" appearing in the statutory phrase "and is not out of earnings or profits" in section 201(d) of the Act of 1924 and corresponding sections of all succeeding statutes down to 1936 (when the phrase was changed) should be interpreted as though they read "earnings or profits accumulated after February 28, 1913." But the words "earnings or profits" are used without limitation, and it is clear from a consideration of the statute and the Congressional Committee reports referred to that the words "earnings or profits" cannot possibly be construed as though they were followed by the phrase "accumulated after February 28, 1913." However, the following analysis of the dividend provisions of the Revenue Acts of 1921 and 1924 will conclusively demonstrate that the words "earnings or profits", as used in section 201(d) of the 1924 Act and in the Congressional Committee reports explanatory thereof, are used without limitation as meaning all earnings or profits whether before or after March 1, 1913. This analysis will be simplified if the pertinent sections of the Acts of 1921 and 1924 are set forth in parallel columns as follows:

*Section 201(d) of the 1924 and 1926 Revenue Acts was continued in the same form as section 115(d) in the subsequent Revenue Acts, except that in 1936 the phrase "and is not out of earnings or profits" was changed to read "and is not a dividend". This change was necessitated by the change occurring in 1936 in the definition of a dividend to include distributions out of the earnings or profits of the taxable year. See discussion *infra*, p. 25 et seq.

Act of 1921

“Sec. 201. (a) That the term ‘dividend’ when used in this title * * * means any distribution made by a corporation to its shareholders or members, whether in cash or in other property, out of its earnings or profits accumulated since February 28, 1913 * * *.

(b) For the purposes of this Act every distribution is made out of earnings or profits, and from the most recently accumulated earnings or profits, to the extent of such earnings or profits accumulated since February 28, 1913; but any earnings or profits accumulated or increase in value of property accrued prior to March 1, 1913, may be distributed exempt from the tax, after the earnings and profits accumulated since February 28, 1913, have been distributed. If any such tax-free distribution has been made the distributee shall not be allowed as a deduction from gross income any loss sustained from the sale or other disposition of his stock or shares unless, and then only to the extent that, the basis provided in section 202 exceeds the sum of (1) the amount realized from the sale or other disposition of such stock or shares, and (2) the aggregate amount of such distributions received by him thereon.

Act of 1924

“Sec. 201. (a) The term ‘dividend’ when used in this title * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, out of its earnings or profits accumulated after February 28, 1913.

(b) For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the basis of the stock provided in section 204.

Act of 1921

(No corresponding section.)

(c) Any distribution * * * made by a corporation to its shareholders or members *otherwise than out of (1) earnings or profits accumulated since February 28, 1913, or (2) earnings or profits accumulated* or increase in value of property accrued *prior to March 1, 1913*, shall be applied against and reduce the basis provided in section 202 for the purpose of ascertaining the gain derived or the loss sustained from the sale or other disposition of the stock or shares by the distributee." (Italics added.)

Act of 1924

(c) (This relates to distribution in partial or complete liquidation and is not material to this discussion.)

(d) If any distribution (not in partial or complete liquidation) made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, *and is not out of earnings or profits*, then the amount of such distribution shall be applied against and reduce the basis of the stock provided in section 204, and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property. * * *'' (Italics added.)

Turning our attention first to the foregoing provisions of the Act of 1924, it will be seen that subsection (a) deals with earnings or profits accumulated after February 28, 1913, and provides that they shall constitute taxable dividends. A portion of subsection (b), which we shall call subsection (b-1), deals with distributions from earnings or profits accumulated before March 1, 1913, and provides that such distributions will reduce the basis of the stock. The remainder of subsection (b), which we shall call subsection (b-2), deals with distributions from increase in value of property accrued before March 1, 1913, and provides that such distributions will reduce the basis of the stock. Subsection (c) deals with distributions in partial or complete liquidation.

Subsection (d) then provides that if a distribution does not come within any of the previous subsections, namely, subsections (a), (b-1), (b-2), or (c), then the distribution will reduce the basis of the stock. It accomplishes this in the following manner:

It first disposes of subsection (c) by stating that the distribution is "not in partial or complete liquidation". It then disposes of subsection (b-2) by stating that the distribution is "not out of increase in value of property accrued before March 1, 1913". It then disposes of subsection (b-1), relating to earnings or profits accumulated *before* March 1, 1913, and all of subsection (a), relating to earnings or profits accumulated *after* February 28, 1913, by providing that the distribution is "not out of earnings or profits."

Congress in subsection 201(c) of the 1921 Act, in stating that if a distribution was not covered by subsections (a) and (b) of that Act it would reduce the basis of the stock, repeated subsections (a) and (b) literally. But in subsection (d) of the 1924 Act Congress deliberately changed the language of the corresponding section of the 1921 Act (subsection (c)), and instead of stating that if a distribution was not out of *earnings or profits accumulated since February 28, 1913*, and was not out of *earnings or profits accumulated before March 1, 1913*, it would reduce the basis of the stock, Congress stated that if the distribution was not out of *earnings or profits* it would reduce the basis. This is conclusive proof that the words "earnings or profits" are used without limitation in subsection (d) of the 1924 Act and mean earnings or profits whenever acquired, either before or after March 1, 1913.

It follows, therefore, that if Oceanic had declared a dividend prior to its liquidation, for example, in 1935, this dividend under the applicable provisions of section 115(d) of the Act of 1934 (identically the same as section 201(d) of the Act of 1924) would clearly have been a distribution of capital specifically required by the statute to be applied in reduction of the basis of the stock, since it would not have been a distribution of earnings or profits* nor a distribution out of increase in value of property accrued before March 1, 1913. Being a distribution of capital to be applied in reduction of the basis of the stock, it could not at the same time have been a dividend as defined by section 115(a). It is clear, therefore, that unless a corporation has "earnings or profits" it cannot have "earnings or profits accumulated after February 28, 1913".

6. The addition in 1936 of Part (2) of the definition of a dividend does not change the meaning of Part (1).

The government may argue that the foregoing statutory analysis is entirely beside the point because the Internal Revenue Code was in effect in 1939 and 1940 when the dividends in question were declared by the Spreckels Company, and section 115(d) of the Internal Revenue Code, as well as section 115(d) of the 1936 Act when Oceanic was liquidated, both change the phrase "and is not out of earnings or profits" to read "and is not a dividend", so that the pertinent portion of the section then read:

*Except to the extent of the small amount of earnings or profits which might then have been on hand after eliminating the deficit as of March 1, 1913.

“(d) Other Distributions From Capital.—If any distribution made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, and is not a dividend, then the amount of such distribution shall be applied against and reduce the adjusted basis of the stock * * *.”

The change in the wording of this section was necessitated by the change in the definition of a dividend made by section 115(a) of the Act of 1936. This section (115(a)) added a new provision to the definition by which distributions from the earnings or profits of the taxable year were subjected to tax without regard to the existence of an operating deficit at the beginning of the year. Since a stockholder's basis should not be reduced if he was subjected to tax on the distribution, it was necessary to make the foregoing change in section 115(d). After the change made in 1936 the pertinent portion of the definition of a dividend, as contained in section 115(a) of the Act of 1936 and the Internal Revenue Code, read as follows:

“(a) Definition of Dividend.—The term ‘dividend’ when used in this title . . . means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.”

The change consisted of the addition of Part (2) to the definition. Why was this change made? The answer is

found in the provisions relating to the new surtax on the undistributed profits of corporations first imposed by the Act of 1936,* which, in the computation of the annual undistributed net income upon which the tax was imposed, allowed a credit only for dividends paid which were taxable in the hands of the recipient. Accordingly, a corporation which had no earnings or profits available for dividends would find itself subject to this new surtax even though it distributed all of its current earnings, since such distributions would not be taxable to the recipients (see *Foley Securities Corp. v. Commissioner*, 106 F.2d 731, CCA 8, 1939). The purpose of the change in the definition of a dividend was to avoid this inequitable result, as explained in the report of the Senate Finance Committee relating to the Act of 1936, and reprinted in 1939-1 (Part 2), C. B. page 689, as follows:

“In order to enable corporations without regard to deficits existing at the beginning of the taxable year to obtain the benefit of the dividends-paid credit for the purposes of the undistributed-profits surtax, section 115(a) changes the definition of a dividend so as to include distributions out of the earnings or profits of the current taxable year. The amendment simplifies the determination by providing that distributions during the year, not exceeding in amount the current earnings, are dividends constituting taxable income to the shareholder and a dividends-paid credit to the corporation. *As respects such dividends* the complicated determination of accumulated earn-

*This tax, which was designed to force corporations to distribute their profits by placing a graduated tax on undistributed income, proved to be impracticable and was abandoned, there being no similar tax enacted with the succeeding Revenue Act in 1938.

ings or profits is rendered unnecessary.” (Italics added.)

Thus the change in the definition of a dividend which was made in 1936, which change is contained in Part (2) of the definition, can have no possible effect upon the meaning of the preceding words in Part (1) of the definition which had remained unchanged ever since the Revenue Act of 1916. The change merely resulted in subjecting to tax distributions out of the earnings or profits of the current year if such distributions are made *within the year*. No problem of accumulated earnings or profits is involved. Since the change in 1936 a dividend is payable first out of the earnings or profits of the current year, but if there are no such profits, or if the distribution exceeds such profits, then recourse must be had to “earnings or profits accumulated after February 28, 1913”—and when this point is reached, it is our contention that the amount of such earnings or profits are necessarily ascertained in the same manner as they would theretofore have been ascertained under each of the Revenue Acts beginning with the Act of 1916. Certainly it cannot be assumed that Congress, having used the identical words, intended to change their meaning.

C. THE GOVERNMENT'S CONSTRUCTION RAISES THE QUESTION OF CONSTITUTIONALITY OF THIS SECTION AS APPLIED TO THE FACTS OF THIS CASE.

The foregoing statutory analysis has demonstrated beyond question that the correct interpretation of the words “earnings or profits accumulated after February 28,

1913'' is that first, there must be earnings or profits, and secondly, in the computation of earnings or profits all earnings or profits accumulated prior to March 1, 1913 are to be eliminated.* The construction contended for by the government immediately raises the question of constitutionality. It is our contention that section 115(a) of the Internal Revenue Code is unconstitutional if it is construed to impose an income tax upon distributions which are in excess of current earnings and where the corporation has no accumulated earnings or profits. Under such circumstances it is our contention that any distribution is a return of capital and therefore not within the terms of the Sixteenth Amendment to the Constitution granting to Congress the power ''to lay and collect taxes on incomes * * *'', and accordingly a tax violative of Section 2 of Article I of the Constitution as being a direct tax not apportioned among the several states. (*Pollock v. Farmers Loan & Trust Co.*, 157 U. S. 429 (1895).)

We note that the government does not believe that the construction of the statute for which it contends raises a constitutional question, apparently relying on the fact that the validity of the amendment made in 1936 taxing distributions from current earnings, even though a deficit in accumulated earnings or profits may exist, has never been questioned. But we are of the opinion that, in so far as constitutionality is concerned, a distinction may well be drawn between the taxation of distributions made from current earnings within the same year that such earnings are realized, and distributions which exceed such current

*Except to the extent that they are absorbed by subsequent losses as held in the *Canfield* case, *supra*.

earnings and made at a time when there are no accumulated earnings to which resort may be had. Consideration was given to this problem at the time of entering into the Stipulation of Facts upon which these cases were tried below, and the three firms of attorneys then representing the various stockholders concluded not to contest the imposition of the tax with respect to dividends declared by the Spreckels Company out of its current earnings for the years involved, but only to contest the taxation of distributions which exceeded current earnings. This conclusion was based upon the conviction that the correct analysis of the statutory provisions involved leads irresistibly to the conclusion that unless a corporation has "earnings or profits" it cannot have "earnings or profits accumulated after February 28, 1913". Thus under the issues as tried no constitutional question would arise.

D. CORRECTION OF MISCELLANEOUS ARGUMENTS IN GOVERNMENT'S BRIEF.

1. This case does not involve a claim for exemption from tax.

The government contends that the taxpayers here are claiming an exemption from tax, and refers to the well-known principle that exemptions are to be strictly interpreted and the taxpayer "must show that he has plainly been touched by the legislative grace" (Pet. Brief, pp. 15-21). The taxpayers here are not claiming that they are exempt from the tax, nor that their incomes are exempt from the tax. They are not asking for special treatment in any respect, so that it could be said that they claim to have been "touched by the legislative grace." They are

merely contending that Congress did not intend to levy a tax on a return of capital.

2. The Tax Court's decision does not render any words in the statute meaningless.

The government in its brief argues that to construe the statute as the Tax Court has done in its decision in this case is to render completely meaningless the words "accumulated after February 28, 1913". It is stated that in so limiting the definition of a dividend Congress could not have been seeking to protect a pre-1913 surplus from being taxed as a dividend when distributed because such protection is provided by section 115 (b). (Pet. Brief, pp. 12-13.) There are two answers. First, when a dividend was first defined in the 1916 Act (section 2(a)) that Act contained no section corresponding to section 115 (b). Such a section was first added in 1917 (section 31 (b) of the 1916 Act, as added by section 1211 of the 1917 Act). Secondly, if section 115 (a) read that "the term dividend means any distribution by a corporation out of its earnings or profits", it would necessarily mean that all dividends from earnings or profits are subject to tax, and this would needlessly conflict with section 115 (b) which exempts from tax distributions of pre-1913 earnings.

3. Government's quotation from *Foster* case is misleading.

The quotation from *Foster v. United States*, 303 U. S. 118, set forth on page 19 of the government brief, is misleading unless read in the light of the obviously tax-dodging scheme under consideration by the court. In that case a family corporation redeemed 25% of its stock by paying \$1,025,000 therefor, and some months thereafter

declared a dividend of \$225,000. The contention was advanced that this dividend was subject to tax only to the extent of the small amount of earnings accruing to the corporation between the date of the redemption of the stock and the date of the dividend. At the time of the redemption of the stock the corporation had undistributed earnings in the amount of \$333,578.98, far in excess of the subsequent dividend, but the plaintiff argued that this amount was completely eliminated by the statutory provision (section 115(b), Act of 1928) that "every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits." Plaintiff then relied upon the further provision of the same section of the statute that earnings or profits accumulated before March 1, 1913 may be distributed exempt from tax after earnings and profits accumulated after February 28, 1913 had been distributed. The Supreme Court held that the payment made in redemption of the stock was not a distribution of earnings or profits within the meaning of the statute, and the language quoted in respondent's brief merely expresses the court's opinion of this scheme to avoid taxation.

**E. THE CASES PRIMARILY RELIED UPON BY THE
GOVERNMENT ARE NOT IN POINT.**

The government has misinterpreted the decision of the Court of Appeals for the Second Circuit in *Hadden v. Commissioner*, 49 F.2d 709 (1931). Because of the great importance which the government attaches to this case (Pet. Brief, pp. 25-26) it will be necessary to examine

the facts and the decision in some detail. The case was tried before the Board of Tax Appeals with the companion case of *Annie P. Kountze*, 17 B. T. A. 928, and the *Hadden* case (which is reported at 17 B. T. A. 956) refers to the *Kountze* case for the facts relating to the dividend issue. Thus the facts here set forth are contained in either the *Kountze* case or the Court of Appeals decision in the *Hadden* case. United Thacker Coal Co. was organized in 1903 and in January 1904, acquired approximately 56,000 acres of undeveloped coal lands which it continued to own until the latter part of 1917. It did not remove and sell any coal and between 1904 and 1917 the company had very little income but did have substantial expenses, with the result that at March 1, 1913 it had a deficit in excess of \$500,000. From that date until April 30, 1917 it sustained an operating loss amounting to \$329,549.22. Between April 30, 1917 and December 22, 1917, the date the dividends in question were declared, it realized a profit of \$735,300 from the sale of some of these coal properties, which profit was calculated on March 1, 1913 values. There were other expenses during the period from April 30 to December 22, 1917 amounting to \$329,350.91, so that the net income before taxes was \$405,949.09. Subtracting accrued income taxes in the amount of \$54,550.28 leaves a net income for the period April 30, 1917 to December 22, 1917 of \$351,398.81.

On the foregoing facts the taxpayers contended before the Board of Tax Appeals in the *Hadden* case that since the net income of \$351,398.81 was considerably less than the March 1, 1913 deficit plus the losses thereafter occurring up to April 30, 1917 in the amount of \$329,549.22,

it followed that there could be no earnings or profits accrued since March 1, 1913. But in a decision reviewed by the Board without dissent the Board pointed out that the petitioners' computation of earnings or profits available for dividends was based on the use of March 1, 1913 values and that whereas this method was proper for the determination of income subject to income tax, in ascertaining whether over a corporation's entire life it has earnings or profits available for dividends the computation must be based on cost. In this connection the Board said (17 B. T. A. 931):

“* * * The petitioner contends that at the time of the distribution, the company had no surplus or undivided profits of any kind. The facts in evidence fail to support this contention, as is demonstrated by a proper computation to arrive at the correct surplus, if any, of the corporation on December 22, 1917. In such computation the profit from the sale of property determined by the use of March 1, 1913, value which was in excess of cost, should not be used alone to offset deficits which occurred *both before and after March 1, 1913*, because the statute contains no provision for the use of March 1, 1913, value in this connection. On the contrary, the profit from the sale in 1917 which should be used to offset operating deficits occurring *both before and after March 1, 1913*, in computing the correct surplus of the company on December 22, 1917, should be determined by using the cost of the property sold. In this way only can we determine whether or not on December 22, 1917, the corporation had any surplus or undivided profits available for the payment of dividends.

“We can not make such a computation in the present case because we do not know the cost of the

property sold. For example, if it had cost only \$2,000,000, the correct book profit from the sale which should be used in wiping out *all past operating deficits* would be far more than sufficient for the purpose. * * *'' (Italics added.)

Although it is clear from the foregoing extract that the Board was of the opinion that there could be no earnings or profits available for dividends until all past operating deficits had been wiped out, including the deficit as of March 1, 1913, nevertheless the Board concluded that it was unable to determine from the record that the Commissioner had erred in holding that certain portions of the distribution received from the coal company in 1917 by Luther Kountze (for whom Hadden was executor) were taxable to him. The reason given by the Board for being unable to determine this question was that the record failed to disclose the number of shares outstanding at the date of the dividend.

An appeal was taken by the taxpayer in the *Hadden* case to the Court of Appeals for the Second Circuit, but apparently no appeal was taken in the *Kountze* case. There were other issues involved in the case but in so far as the dividend issue was concerned the taxpayer made no contention before the Court of Appeals that the deficit on March 1, 1913 had not been restored, but after setting forth the figures discussed above with respect to gains and losses thereafter realized he contended that from the net income of \$351,398.81 for the period April 30, 1917 to December 31, 1917 there should be deducted the losses realized from March 1, 1913 to April 30, 1917 in the amount of \$329,549.22, leaving an amount available

for dividends on December 22, 1917 of \$21,849.59. Luther Kountze's share* of this was \$6,086.64, which the taxpayer contended was the amount of the taxable distribution received. Bearing in mind that the tax on this amount at 1917 rates would be very low (in fact it would not exceed \$500 if we assume the taxpayer's income did not exceed \$100,000), it is apparent that rather than attempt to prove the original cost of all the property sold in 1917 the taxpayer had concluded to abandon the argument that the deficit as of March 1, 1913 had not been fully restored. In ascertaining the earnings or profits which had accrued since 1913 it is proper to use March 1, 1913 values and accordingly the taxpayer was able to demonstrate that the amount involved was so small as not to warrant the expense of establishing original cost, particularly in view of the fact that the books of the corporation had been destroyed by fire in 1912. On the other hand, the Commissioner had nothing to gain by attempting to increase earnings or profits over the corporation's entire life by reducing original cost since the increase would merely represent an increased realization of March 1, 1913 appreciation and consequently tax free when distributed (section 115(b)). Thus before the Court of Appeals both parties agreed to take the position that the dividend issue could be determined by taking into consideration only the gains and losses realized since March 1, 1913. The Court of Appeals agreed with the taxpayer's position that the taxable dividend which he

*On the appeal the Commissioner stipulated with respect to the number of shares outstanding at the date of the dividend and accordingly this cured the defect in the record which prevented the Board from arriving at the same conclusion as the Court of Appeals.

had received was \$6,086.64. It is apparent that the language quoted in the government brief must be read in the light of the fact that the only matter before the court, in so far as the dividend issue was concerned, was the ascertainment of the earnings or profits of the corporation for the period March 1, 1913 to December 22, 1917. In considering this question the court pointed out that there must be subtracted from the 1917 profits on the sale of land the losses sustained between March 1, 1913 and April 30, 1917, and it was in support of this proposition that the Tax Court cited the case (R. 76). It is clear, therefore, that the government erred in stating that the case stands for the "exact opposite" of the proposition for which it was cited by the Tax Court. The government was also in error in stating that the Tax Court overlooked completely the fact that the Circuit Court did not deduct the \$500,000 deficit as of March 1, 1913, and that "the Tax Court's reasoning embodies a patent *non-sequitur*". (Pet. Brief, pp. 25-26).

The government also relies on *Hoffman v. United States*, 53 F.2d 282 (Ct. Cl. 1931), as a case in which the court assumed that a March 1, 1913 deficit did not have to be restored by subsequent earnings before there could be earnings or profits available for dividends. However, the decision of the Court of Claims in this case, which involved the taxability of a dividend declared in 1917, was based on a prior decision of that court in *Blair v. United States*, 63 Ct. Cl. 193 (1927), which held that a dividend paid in 1918 out of the current earnings of a corporation was taxable even though such current earnings were less than an operating deficit *at the*

beginning of the year. In the *Hoffman* case the Court of Claims had the same question before it, although the facts were somewhat more complicated, and followed the *Blair* case in holding that current earnings are subject to tax when distributed irrespective of prior operating deficits even though incurred since 1913. This explains its dictum quoted on page 27 of the government brief that if the profit of 1913 had been distributed in 1913, the distribution would have been taxable notwithstanding the existence of a prior operating deficit.

The Court of Claims was, however, in error in its conclusion that current earnings are subject to tax when distributed irrespective of a prior operating deficit, and it has since become well established that the prior operating deficit must be restored before there are accumulated earnings available for dividends. See for example *Foley Securities Corp. v. Commissioner* (C.C.A. 8, 1939), 106 F.2d 731; *Hadden v. Commissioner*, *supra*; *J. L. Washburn*, 16 B.T.A. 1091 (1929); G.C.M. 1552, VI-1 C. B. 10.

In *Foley Securities Corp. v. Commissioner*, *supra*, Judge Sanborn, speaking for the Circuit Court of Appeals for the Eighth Circuit, says, 106 F.2d 733:

“The taxpayer contends that, in computing the surtax, the Commissioner should have deducted, as a dividend, from its ‘adjusted net income’ the entire \$42,375 which it had distributed to its shareholders. In support of this contention it cites *Blair v. United States*, 63 Ct. Cl. 193, certiorari denied 275 U. S. 546, 48 S. Ct. 84, 72 L. Ed. 418, which, in effect, held that a distribution to shareholders out of current earnings was a ‘dividend’, although the capital of

the corporation was impaired at the time the distribution was made. The Board of Tax Appeals has expressly refused to follow the *Blair* case (*Washburn v. Commissioner*, 16 B.T.A. 1091, 1098; *Shorb v. Commissioner*, 22 B.T.A. 644, 645), relying in part upon *Willcuts v. Milton Dairy Co.*, 275 U. S. 215, at page 218, 48 S. Ct. 71, at page 72, 72 L. Ed. 247, in which the Supreme Court said: 'But it is a prerequisite to the existence of "undivided profits" as well as a "surplus," that the net assets of the corporation exceed the capital stock. Hence, where the capital is impaired, profits, though earned and remaining in the business, if insufficient to offset this impairment do not constitute "undivided profits."' The Supreme Court also held in that case that the words 'undivided profits,' as commonly understood, describe such part of the excess in value of the corporate assets as consisted of profits which had neither been distributed as dividends nor carried to surplus account.'

In explaining its refusal to follow the *Blair* case, the Board of Tax Appeals in *J. L. Washburn*, *supra*, stated that

"* * * The interpretation there placed upon *Edwards v. Douglas*, 269 U. S. 204, cited by the Court of Claims in support of its decision, can not be sustained in the light of the Supreme Court's decision in *Willcuts v. Milton Dairy Co.*, *supra*."

The decision of the Board of Tax Appeals in *J. L. Washburn*, *supra*, was written by its then Chairman, Judge Littleton, and was approved by the entire Board on this point. At the time of the decision of the Court of Claims in the *Hoffman* case, Judge Littleton had be-

come a member of the Court of Claims and wrote an opinion dissenting in part. Judge Littleton, of course, refused to agree with the opinion of the majority that current earnings are taxable when distributed irrespective of the existence of a prior operating deficit. The majority being of the opinion, as we have stated, that no prior deficits need be restored, did not separately consider and pass upon the question as to whether or not the deficit existing as of March 1, 1913 in that case need be restored. Judge Littleton, since he was of the opinion that prior deficits must be restored, did have to give consideration to the operating deficit which existed at March 1, 1913. In referring to the earnings for the period March 1, 1913 to December 31, 1913 he makes the statement that "this amount is insufficient to make up the deficit existing March 1, 1913, *and thus create a surplus from which a dividend might be declared * * *.*" (Italics added.)

After analyzing the accounts down through 1917 and adjusting for the difference between depletion on March 1, 1913 values and depletion on cost, Judge Littleton finds that there were sufficient earnings to cover all dividends declared *after restoring the March 1, 1913 deficit* and that it was, therefore, unnecessary to take this deficit into account in the computations which are set forth in his opinion. Both the majority opinion and Judge Littleton's opinion contain tables showing the computation of earnings available for dividends subsequent to March 1, 1913, and in order to keep his computation on a basis comparable to the computation contained in the majority opinion, Judge Littleton did not desire to inject into his

computation the restoration of the deficit existing on March 1, 1913 unless this was necessary. In his opinion Judge Littleton said:

“ * * I have not considered the deficit existing at March 1, 1913, for the reason that at all times there was a surplus sufficient to extinguish the deficit and pay the dividend. A dividend can, of course, only be paid when a surplus exists, * * *.”* (Italics added.)

Thus the majority of the court in the *Hoffman* case gave no consideration to the question as to whether or not a March 1, 1913 deficit should be restored and this case can only be cited for the proposition, previously decided by the Court of Claims in the *Blair* case, that no prior deficit need be restored, even deficits which have been incurred since March 1, 1913. As we have seen, this proposition has since been discredited.

CONCLUSION.

It has been shown that the construction of the statute contended for by the government will lead to an economic absurdity in the instant case. It is also clear that this construction of the statute necessarily results in taxing as a dividend that which in actuality is a distribution of capital, thereby raising a constitutional question. It is accordingly apparent that such a construction of the statute should not be adopted unless no other construction is possible. But we have shown, we believe, that such a construction is not only contrary to well-recognized principles of corporation law which require that impaired capital be restored before there can be earnings or profits

available for dividends, but is also contrary to the construction which must be given to the statute if consideration be given to its historical development as set forth herein. Such consideration conclusively establishes that an operating deficit existing on March 1, 1913 must be offset by subsequent earnings or profits before there can be "earnings or profits accumulated after February 28, 1913."

The decision of the Tax Court of the United States should be affirmed.

Dated, San Francisco, California,
March 7, 1951.

Respectfully submitted,

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12,663.*

(Appendix Follows.)

Appendix.

Appendix

Revenue Act of 1916, c. 463, 39 Stat. 756:

Sec. 2. (a) That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever: *Provided*, That the term "dividends" as used in this title shall be held to mean any distribution made or ordered to be made by a corporation, joint-stock company, association, or insurance company, out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation, joint-stock company, association, or insurance company, which stock dividend shall be considered income, to the amount of its cash value.

Revenue Act of 1917, c. 63, 40 Stat. 300:

Sec. 1211. That Title I of such Act of September eighth, nineteen hundred and sixteen, is hereby amended by adding to Part III six new sections, as follows:

* * * * *

Sec. 31. (a) * * *

(b) Any distribution made to the shareholders or members of a corporation, joint-stock company, or association, or insurance company, in the year nineteen hundred and seventeen, or subsequent tax years, shall be deemed to have been made from the most recently accumulated undivided profits or surplus, and shall constitute a part of the annual income of the distributee for the year in which received, and shall be taxed to the distributee at the rates prescribed by law for the years in which such profits or surplus were accumulated by the corporation, joint-stock company, association, or insurance company, but nothing herein shall be construed as taxing any earnings or profits accrued prior to March first, nineteen hundred and thirteen, but such earnings or profits may be distributed in stock dividends or otherwise, exempt from the tax, after the distribution of earnings and profits accrued since March first, nineteen hundred and thirteen, has been made. This subdivision shall not apply to any distribution made prior to August sixth, nineteen hundred and seventeen, out of earnings or profits accrued prior to March first, nineteen hundred and thirteen.

* * * * *

Internal Revenue Code:

Sec. 115. Distributions by Corporations.

(a) Definition of Dividend.—The term “dividend” when used in this chapter (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed

as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) Source of Distributions.—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

* * * * *

(d) Other Distributions from Capital.—If any distribution made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, and is not a dividend, then the amount of such distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113, and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property. This subsection shall not apply to a distribution in partial or complete liquidation or to a distribution which, under subsection (f) (1), is not treated as a dividend, whether or not otherwise a dividend.

* * * * *

(26 U. S. C. 1940 ed., Sec. 115.)

(Sections 115 (a) and (b) are identically the same, and section 115 (d) is in all material respects the same, under the Revenue Acts of 1938 and 1936.)

No. 12664

In the United States Court of Appeals
for the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

GRACE H. KELHAM, LEILA H. NEILL, ELLIS M. MOORE,
HARRIET H. BELCHER, AND LILLIE S. WEGEFORTH,
RESPONDENTS

ON PETITIONS FOR REVIEW OF THE DECISIONS OF THE TAX
COURT OF THE UNITED STATES

REPLY BRIEF FOR THE PETITIONER

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PAUL P. O'NEIL

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REPLY BRIEF FOR THE PETITIONER

The taxpayers' contention, in their own language, is that (Br. 19-20) "an operating deficit as of March 1, 1913 must be restored by subsequent earnings before there are any accumulated earnings or profits available for dividends." Again, it is stated (Resp. Br. 7) "It is a contradiction in terms to say that a corporation has accumulated profits when its capital is impaired." This contention and this observation, which express the ultimate import of the taxpayers' argument, would possess validity if the statute under consideration simply made the corporation's accumulated earnings or profits the frame of reference for ascertaining what corporate distributions should be taxable as divi-

dends to the stockholders. Code Section 115 (a)(1), however, is concerned with earnings or profits “*accumulated after February 28, 1913,*” (italics added) a date which the taxpayers conveniently overlook or minimize. There is, however, no contradiction in concluding that a corporation can accumulate profits after a specified date despite the existence of a prior deficit—so long as the deficit was incurred before the date specified in the statute as the starting point for making the measurement. It is the taxpayers’ argument which seeks to contradict the statute, for they contend that no matter what Section 115 (a) says about profits accumulated after February 28, 1913, it really means that such profits are to be measured by what was accumulated during the entire corporate history, if the corporation possessed a deficit on March 1, 1913.

To the extent that the taxpayers’ brief simply echoes the rationale employed by the Tax Court, no reply seems necessary. We believe that the Commissioner’s opening brief has sufficiently demonstrated that none of the reasons advanced below justify the manner in which the Congressional purpose has been obfuscated and the statutory language ignored. To the extent that the taxpayers now renew additional arguments in an attempt to bolster the decision below, we shall demonstrate them to be without merit, a conclusion which even the Tax Court seems to have shared since it did not see fit to adopt those arguments in its opinion.

A. The Constitutional Argument

The taxpayers assert that it would be unconstitutional for Congress to tax as income to the shareholders any distribution out of corporate earnings accumulated after February 28, 1913, without first applying such earnings to eradicating a corporate deficit existing on

March 1, 1913. (Br. 28-30.) The constitutional objection is founded on the assumption that such a distribution would be (Br. 29) "a return of capital" and not income "within the terms of the Sixteenth Amendment to the Constitution * * *." The notion that such a distribution involves a return of capital is also repeated by the taxpayers elsewhere. (Br. 15, 31.)

A contention that a statute would be unconstitutional if construed in harmony with the legislative intent ought not to be lightly advanced. It is surprising, therefore, that, having raised such a serious matter, the taxpayers should not bother to elucidate how such distributions would constitute a return of capital or cite any authority to prove their assertion. Any consideration of the matter, however, will make it apparent that there is not the slightest foundation to support the taxpayers in this matter.

Initially, it should be observed, as we pointed out in our opening brief (p. 20), that Congress, ever since 1936, has taxed the shareholders on all distributions out of the corporation's current earnings and profits, even though the corporation may possess an accumulated deficit in its earnings and profits at the time when the distribution is made;¹ no one has ever challenged the validity of this. Indeed, while this very matter was involved in the computations required by these cases, the taxpayers here do not question the power of Congress to tax such distributions as income. (Resp. Br. 30.)

If a distribution of current earnings to the stockholders does not constitute a return of capital, notwithstanding that the corporation's capital is then

¹ It should be noted that, while this provision originated in Section 115 (a), clause (2) of the Revenue Act of 1936, c. 690, 49 Stat. 1648, when the tax on undistributed profits came in, it remained even after that tax failed to be renewed, and it exists today in Code Section 115 (a).

impaired, we fail to comprehend how a corporate distribution involves a return of capital if there is a pre-1913 deficit which has not been restored. We note that counsel for the taxpayers (Br. 29-30) state that they considered this matter and concluded that such a distinction does exist. However, we can discover no valid basis for their conclusion and they have demonstrated none. If the statute is unconstitutional in the respect claimed by the taxpayers it must also be considered invalid in taxing distributions out of current earnings when there is an existing deficit.

The absurdity of this constitutional objection, however, seems plain. If a stockholders^x "equity" in the corporation's surplus as of March 1, 1913, does not represent capital to him, so that a subsequent distribution of that surplus may be constitutionally taxed, as was held in *Lynch v. Hornby*, 247 U.S. 339, it is an *a fortiori* conclusion that, where the corporation has a deficit on that date and later makes distribution out of subsequent earnings, no capital is being returned to the shareholder. So long as the stockholder's stock interest in the corporation is retained by him, any distribution of the corporation's earnings is a return *on* his capital, not a return *of* his capital, and the gains thereby derived can be constitutionally taxed as income to him. It makes no difference when those earnings inured to the corporation, or what effect their declaration as a dividend has on the corporation making the distribution. *Lynch v. Hornby*, 247 U.S. 339, 344, 346. The income, in its constitutional sense, received by a stockholder who receives a dividend out of corporate earnings is not affected by whether the corporation does or does not possess a deficit at that time. Since the stockholder's interest as a stockholder remains intact, his capital remains intact, and such a distribution does not at all involve a return of capital to him. Cf. *United*

States v. Phellis, 257 U.S. 156, 171-172; *Taft v. Bowers*, 278 U.S. 470, 483-484; *Koshland v. Helvering*, 298 U.S. 441; *United States v. Safety Car Heating Co.*, 297 U.S. 88.

What the taxpayers are really contending for is a constitutional rule requiring Congress to restore to them the "equity" which they would have possessed on March 1, 1913, if the corporation had not suffered losses and an impairment of its capital before that time. No such guarantee was imposed by the Sixteenth Amendment. See *Lynch v. Hornby*, *supra*. Cf. *Helvering v. Canfield*, 291 U.S. 163.

Since Congress could constitutionally tax such distributions, it seems plain that the Tax Court could not be right in its conclusion unless Congress has refrained, in this particular respect, from exercising its constitutional power to the fullest. The pertinent question that must be answered is why Congress should have considered that such income ought not to be taxed. Neither the Tax Court nor the taxpayers have suggested a single, valid reason which would have motivated the legislature to do so.² On the contrary, as we have shown, the only legislative purpose has consistently been to tax, when distributed, all corporate profits accumulated after March 1, 1913, as well as distributions out of current earnings. (Pet. Br. 16-20.)

B. The Argument Based on Other Statutory Provisions

In the attempt to prove that Section 115(a)(1) does not mean what it says in referring to earnings or profits

² The only explanation offered by the taxpayers is on the theory that Congress did not create an exemption but that, because of constitutional limitations (Br. 30-31), "Congress did not intend to levy a tax on a return of capital." Since the assumption that this is a return of capital is fallacious, we are left with no explanation at all respecting why Congress should have exempted such income when it could have constitutionally subjected it to tax.

“accumulated after February 28, 1913,” the taxpayers make an involved argument (Br. 19-28) based on the language of Section 201 (d) of the Revenue Act of 1924, c. 234, 43 Stat. 253, and corresponding provisions of intervening Acts, prior to those of the Revenue Act of 1936. While the exact purport of what is supposed to be established by this argument is far from clear, we shall show that nothing of aid to the taxpayers has been or can be proved by the provisions referred to.

Prior to the Revenue Act of 1921, there was no statutory provision dealing with the effect on the basis of stock to a shareholder who received corporate distributions which were not taxable as dividends or which were not otherwise exempt from tax. Such a provision was enacted in Section 201 (c) of the Revenue Act of 1921, c. 136, 42 Stat. 227, which in effect, provided that such distributions to the shareholders would reduce the basis of the stock for the purpose of determining gain or loss on a subsequent disposition of the stock. It did this, it should be noted, by language geared to Section 201 (a) and (b) which contained the definition of a taxable dividend. That is, Section 201 (c) referred to distributions which were not out of earnings accumulated, or increased in value accrued, prior to March 1, 1913; it provided that all other distributions (since these would not constitute taxable dividends under Section 201 (a) and would not be exempt from tax under Section 201 (b)) should be applied against the basis of the stockholder's stock.³

It should be emphasized that, because Section 201 (c) repeated the exact language of Section 201 (a) and (b), there can be no doubt that the legislature was pro-

³Section 201 (b) made a separate provision providing that distributions out of pre-1913 earnings should reduce the basis of the stock for purposes of loss. Being silent on the matter, the statute did not require such a reduction of basis for purposes of determining subsequent gain.

viding that a distribution should reduce basis only if it was not a taxable dividend under Section 201 (a) or was not exempt from tax under Section 201 (b). The repetition of the language of Section 201 (a) and (b), to the extent that it casts light on the Congressional intent regarding the present problem, actually strengthens our argument that Congress was not repeating unnecessary language when it separately referred to earnings or profits "accumulated since February 28, 1913" and that it did not intend that the crucial date should be read out of the statute. (See Pet. Br. 12-15.)

Section 201 (a) and (b) of the 1924 Act contained the same essential definition of a dividend as was embodied in the 1921 Act. Section 201 (b) made one major change over existing law by providing that distributions out of pre-1913 earnings should reduce the basis of the stock for both gain and loss. H. Rep. No. 179, 68th Cong., 1st Sess., p. 11 (1939-1 Cum. Bull. (Part 2) 241, 249); S. Rep. No. 398, 68th Cong., 1st Sess., p. 11 (1939-1 Cum. Bull. (Part 2) 266, 274). (See fn. 3, *supra*.)⁴ Section 201(d) of that Act corresponded to Section 201 (c) of the 1921 Act. The only change of substance was the addition of a sentence to the effect that its provisions should apply so that distributions from depletion reserves based on discovery value should also reduce the basis of stock. That section also stated explicitly that, to the extent that such distributions exceeded basis, the distributees should be taxed with gain. This was only inherent in the 1921 Act, but its provisions had been so applied and the language of the 1924 Act was considered declarative of existing law. (H. Rep. No. 179, *supra*, p. 12; S. Rep. No. 398, *supra*, p. 12.)

⁴ Such distributions, to the extent that they exceeded basis, however, were not taxable as gain until Section 115 of the Revenue Act of 1936.

The language of Section 201 (d) of the 1924 Act, however, differed in other respects from the 1921 Act. Unlike the 1921 Act, which referred to distributions which were not out of earnings or profits accumulated since February 28, 1913, or out of those accumulated prior to March 1, 1913, Section 201 (d) of the 1924 Act simply referred to distributions which were not out of "earnings or profits." The taxpayers' argument is premised on the assumption that (Br. 24) "Congress deliberately changed the language" and that it meant "earnings or profits whenever acquired, either before or after March 1, 1913." The conclusion which the taxpayers would apparently have this Court derive is that, because of this change in Section 201 (d), the statutory definition of a dividend (even though that Act (Section 201 (a) and (b)) as was true of all prior and succeeding Acts, and the Internal Revenue Code, constantly defined a dividend in relation to earnings or profits accumulated after February 28, 1913) did not mean that the accumulations were to start their measurement on March 1, 1913. The argument, however, is one where both the major and minor premises are erroneous, so that the conclusion is inescapably fallacious.

The basic assumption that the change in language in Section 201 (d) of the 1924 Act represented a deliberate intention by Congress to change the meaning of the previous statutory provisions in this respect, is directly contradicted by the legislative history. Thus, the House Committee Report (H. Rep. No. 179, *supra*, p. 12) which otherwise specifically described all changes in substance that were being made over the 1921 Act, did not even intimate that any changes were contemplated in this respect by Section 201 (d). It merely stated that that section (p. 12) "corresponds to subdivision (c) of section 201 of the existing law." It proceeded to paraphrase the new language, but said noth-

ing to indicate that a substantive change was intended. The same is true of the Senate Finance Committee Report which, significantly, did describe a change of substance recommended by that committee and which was subsequently enacted into law, namely the extension of the section to apply to distributions from depletion reserves based on discovery value. (S. Rep. No. 398, *supra*, p. 12.) In view of the failure of the committees to indicate otherwise, the only permissible conclusion is that the 1924 Act did not intend to make any change in substance respecting the meaning of a dividend, and that Section 201 (d) was still geared to Section 201 (a) and (b).

Furthermore, if Congress had intended to change the definition of a dividend, it seems safe to suppose that the legislature would have altered the language of definition contained in Section 201 (a), and would not, in describing what are dividends, have employed a devious approach hidden in the provisions relating to distributions which were not dividends. The fact that Section 201 (a) and (b) was not altered in this respect, and has never yet been so changed, is conclusive that no such alteration in meaning has ever occurred.

The taxpayers might be suggesting that Congress, in 1924, intended to achieve the same result that the Tax Court reached in this case, and, realizing that the existing statutory language of Section 201 (a), in referring to what was accumulated since February 28, 1913, was not accurate, attempted to correct the statutory language to accord with the legislative intent. If this is what the taxpayers are urging, the same answer suffices—if Congress had so intended, it would have revised the definition of a dividend in Section 201 (a)—not the provisions relating to capital distributions in Section 201 (d).

The ultimate conclusion is plain—the 1924 Act in no respect changed the nature of what distributions should be taxed as dividends and what distributions should be considered as returns of capital. The purpose to tax as dividends all distributions out of earnings accumulated after March 1, 1913, remained the same as it was before and as it has been ever since. The taxpayers merely assume the conclusion yet to be proved, and do so erroneously, when they assert (Br. 25) that in 1935 Oceanic could have distributed its earnings which were accumulated after February 28, 1913, and that such a distribution would have been considered a return of capital to the stockholders. There never has been a time when such a distribution would not have been taxed as a dividend to the distributees.

C. The Claim of Inconsistency

The taxpayers go far afield in a futile attempt to establish that the present position of the Commissioner has not always been the view of the Bureau of Internal Revenue. The reference (Resp. Br. 10-11) to the excess profits tax provisions of the Revenue Acts of 1918 and 1921, and to Article 838 of Treasury Regulations 45 and 62, promulgated thereunder, which required an examination of profits and losses “from the original organization of the corporation down to the taxable year,” is entirely misplaced. Thus, Section 326 (a) (3) of the Revenue Act of 1918, c. 18, 40 Stat. 1057, included in invested capital “paid-in or earned surplus and undivided profits.” Since Congress was interested in what investment of the stockholders remained in the business, the statute made no distinction between profits accumulated before or after March 1, 1913, and the Commissioner’s Regulations properly referred to the entire corporate history.⁵

⁵ *Troy Record Co. v. Commissioner*, 11 B.T.A. 298, on which the taxpayers rely (Br. 11-12), establishes nothing. The issue there

Thus, there is an important distinction between what is included in invested capital and what is the source of dividends, the latter but not the former making accumulations after February 28, 1913, an important line of demarcation. The taxpayers' difficulty is that here, as elsewhere, there is a subtle attempt to overlook the statutory language which defines a dividend and which does make it important to determine what has been accumulated since February 28, 1913. For the same reason, the reference (Resp. Br. 12-13) to G.C.M. 1552, VI-1 Cum. Bull. 10 (1927), which involved a post-1913 deficit, has no relevance to the situation here. (See Pet. Br. 24-25.)

D. The Canfield Decision

In contending (Br. 13-15) that the Commissioner's position in this case was repudiated in *Helvering v. Canfield*, 291 U. S. 163, the taxpayers misconceive not only the Commissioner's contentions here but also what was decided by the Supreme Court in that case. The taxpayers state that the Commissioner is contending that (Br. 13) "to determine earnings or profits accumulated since March 1, 1913, it is merely necessary to strike a balance of gains and losses since that date" and that the *Canfield* case (Br. 14) "conclusively establishes that the concept of the government in the instant case * * * is fallacious."

The Commissioner's position has been misinterpreted by the taxpayers and there is nothing in our opening brief which could possibly warrant this. The

involved the amount of invested capital and there was no issue respecting the taxability of the dividends. The decision, moreover does not disclose sufficient facts to permit any conclusion whether, if that had been the issue, the dividends would have been taxable, i.e., whether there were sufficient earnings accumulated after March 1, 1913. The inference that the Commissioner took a position in that case inconsistent with the contentions made here is not warranted.

Commissioner's contention has been plainly stated, namely, that Section 115 (a) of the Code requires an ascertainment of what earnings or profits have been accumulated after February 28, 1913, and that Congress plainly intended to tax as dividends all distributions made out of corporate profits accumulated since that time. (See Pet. Br. 11-12, 14, 15-16, 19, 24.)

In the *Canfield* case, *supra*, the Court, consistent with what we maintain should be the result in this case, looked to the aggregate earnings and profits in the post-1913 period and determined that the amount accumulated in that period exceeded the distributions in question. Accordingly, those distributions were ruled to be taxable as dividends. In the present case, it is similarly true that the earnings and profits in the post-1913 period exceeded such distributions (or passed to the Spreckles Company in sufficient amount to make its distributions taxable as dividends) and the same result should follow.

In the *Canfield* case, the more recent accumulations were properly held to be undiminished by the earlier, post-1913 losses since those losses reduced the pre-1913 surplus and, consequently, did not affect the amount of the later, post-1913 accumulations. What was accumulated after March 1, 1913, in that case was definitely affected by what surplus had been accumulated before that time, since this surplus was actually reduced by the earlier, post-1913 losses.

In the present situation, however, there is no occasion to look beyond March 1, 1913. Since there was a corporate deficit on that date, nothing in the prior corporate history could affect the amount of earnings and profits accumulated after that time. The patent error committed by the taxpayers is in thinking that, because a March 1, 1913 surplus remains available to absorb subsequent losses so that they do not diminish later accumulations of profits, it follows that a deficit

on March 1, 1913 (Br. 14-15) “likewise remains available to absorb subsequent earnings.” But this is a complete *non-sequitur* and arises from the taxpayers’ confused notion (Br. 15) “that to ignore the operating deficit is to tax as income that which in reality is a distribution of capital.”

The *Canfield* case demonstrates that the contrary is true, and establishes this as an *a fortiori* situation for taxing the distributions. In *Canfield* the losses which took place immediately after 1913, as a physical fact, had reduced the assets existing on March 1, 1913, so that the later earnings represented augmentations of the corporation’s worth and were accumulations available for dividend purposes. Here, too, the post-1913 earnings augmented the corporation’s worth and, indeed, all those earnings augmented it over that existing on March 1, 1913—a matter which was not even true in *Canfield*. There is no reason why, consistent with the Congressional plan to tax such earnings when distributed (*Helvering v. Canfield, supra*, p. 168), they should not be available for distribution as taxable dividends. Furthermore, if the surplus existing on March 1, 1913, in the *Canfield* case was not to remain as undisturbed capital belonging to the stockholders, it is all the more clear that losses before that date need not be restored to guarantee the stockholders a theoretical capital equal to what would have been their investment if operating losses had not been incurred by the corporation before 1913. We need not repeat the analysis in our opening brief which, in all respects, demonstrates why the *Canfield* case is actually inconsistent with the result below. (Pet. Br. 15-21.)

In conclusion, passing reference may be made to the contention (Resp. Br. 4-6) that the Commissioner’s position is one of “economic absurdity” which leads

to an "anomalous result." The anomaly is said to result from the supposed conclusion that there would be a different result if the stock were sold by the stockholders or if the corporation were liquidated and its assets sold. Even if this difference could be conceded to be correctly supposed (which we do not concede) nothing has been proved. In *Commissioner v. Phipps*, 336 U.S. 410, 419, the Court was referring to just such different ways of accomplishing a result and said: "We note in passing, in this connection, that such gain will correspond, if at all, only by coincidence with the amount of earnings and profits of the subsidiary." There are many instances where different tax results ensue when different transactions are carried out, even though the ultimate economic effect may be similar or the same. See also *United States v. Cumberland Pub. Serv. Co.*, 338 U.S. 451, 455, where the Court said:

Congress having determined that different tax consequences shall flow from different methods by which the shareholders of a closely held corporation may dispose of corporate property, we accept its mandate. * * *

Other matters argued by the taxpayers have either been fully covered in our opening brief or else are so patently erroneous as to require no further answer.

The decision of the Tax Court should be reversed.

Respectfully submitted,

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MARCH, 1951.

No. 12,664

IN THE

United States Court of Appeals
For the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

VS.

GRACE H. KELHAM, LEILA H. NEILL, ELLIS
M. MOORE, HARRIET H. BELCHER, and
LILLIE S. WEGEFORTH,

Respondents.

PETITION FOR REHEARING.

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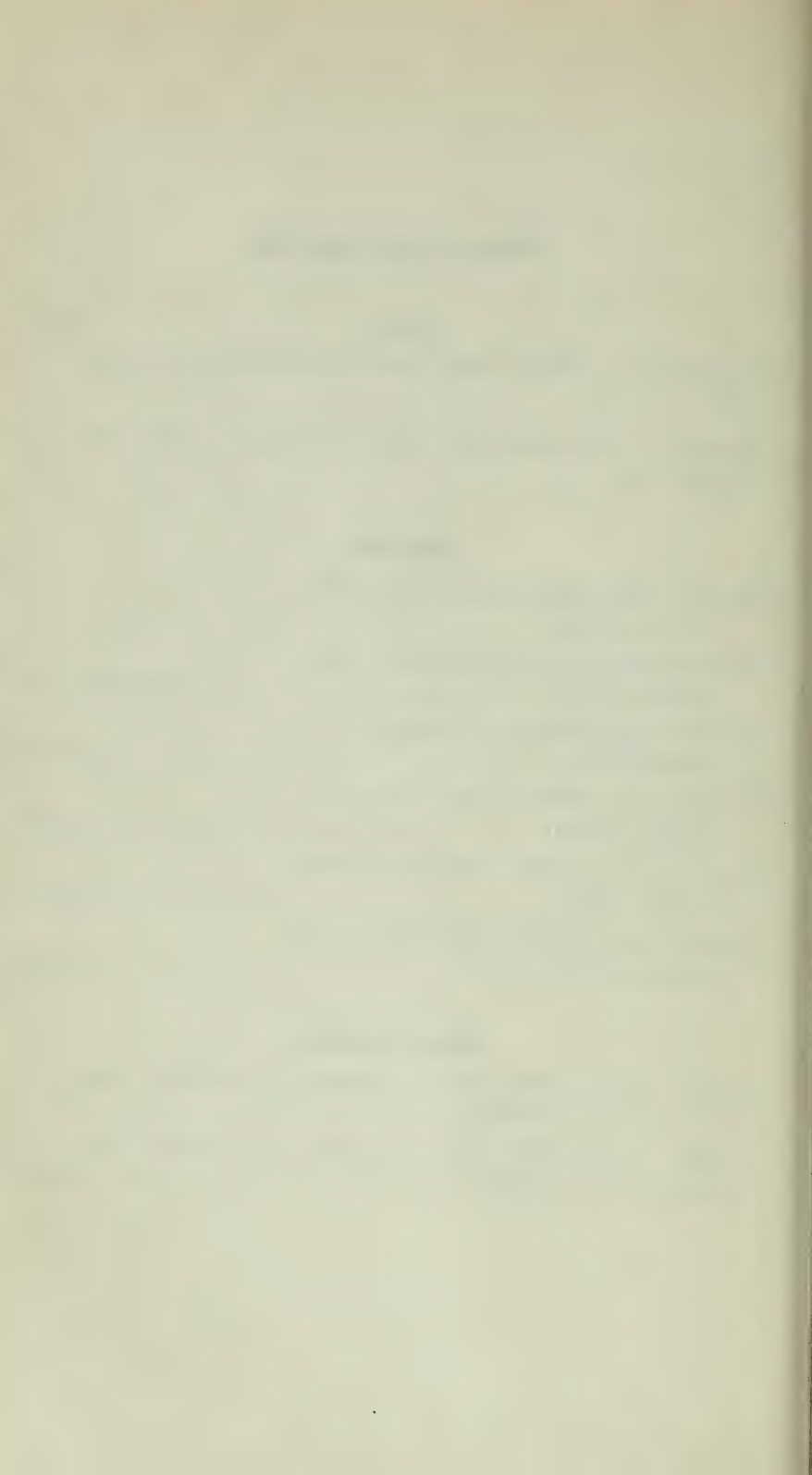


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M. MOORE, HARRIET H. BELCHER, and
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Respondents.

PETITION FOR REHEARING.

*To the Honorable William Denman, Chief Judge, and to
the Honorable Associate Judges of the United States
Court of Appeals for the Ninth Circuit:*

This petition for a rehearing is filed because we are convinced it can be conclusively shown that the decision of the Tax Court should be affirmed.¹

The decision of this Court results in taxing to the stockholders of the Spreckels Company distributions of capital. These distributions were unquestionably distribu-

¹Twelve judges of the Tax Court concurred in the majority opinion.

tions of capital in an *accounting* sense. They were unquestionably distributions of capital in a *legal* sense. And they were *in fact* distributions of capital. Almost all the stockholders of the Spreckels Company sustained very large losses unusable for tax purposes upon the final liquidation of the company on December 31, 1948, in spite of the fact that their cost basis had been reduced by the distributions here involved and those occurring in subsequent years which were treated as distributions of capital.² The decision in this case, which will of course be controlling in subsequent years, will further increase the very large losses realized upon final liquidation by another \$5,000,000 as a result of taxing as dividend income what in fact was but a partial return of capital.

It is a general principle of corporation law that dividends paid in the face of an operating deficit are regarded as paid from capital. The opinion of this Court recognizes the existence of this legal principle but states that it is of no importance here. But this principle is the recognition of a basic concept of *universal* application. It is a basic concept of the terms "earned surplus," "undivided profits" and "earnings or profits" that a corporation can have no earned surplus, or undivided

²The Spreckels Company had been in the process of liquidation for some years prior to the years 1939-1940 here involved. It had sold various capital assets and distributed the proceeds, and its stockholders had paid taxes on all these proceeds until its earned surplus, including the inherited earned surplus of Oceanic, was exhausted. Thereafter the stockholders paid tax on all distributions to the extent of the current earnings of the corporation. It was only such distributions as exceeded both the current earnings and the earned surplus which were treated as distributions of capital.

profits, or earnings or profits unless its assets (after providing for liabilities) exceed its capital. It was the recognition of this basic concept which caused the Supreme Court to decide in *Willcuts v. Milton Dairy Co.*, 275 U. S. 215, 218, that

“* * * it is a prerequisite to the existence of ‘undivided profits’ as well as a ‘surplus,’ that the net assets of the corporation exceed the capital stock. Hence, where the capital is impaired, profits, though earned and remaining in the business, if insufficient to offset this impairment do not constitute ‘undivided profits.’ ”

Of course a corporation with an operating deficit, that is to say with an impaired capital, can have annual income. No one denies that Oceanic had annual income while it was restoring its impaired capital and that this income was subject to income tax and was in fact taxed, but Oceanic did not have an earned surplus, or undivided profits, or earnings or profits.

It may be that a corporation with an impaired capital may also be said to have undivided profits, or earnings or profits, *of the current year*. Congress was of this opinion when it added, in 1936, the second portion of the definition of a dividend which included within the definition a “distribution made * * * out of the earnings or profits of the taxable year.” But certainly a corporation cannot be said to have an *accumulation* of earnings or profits unless it has undivided profits as defined by the Supreme Court, or an earned surplus, that is to say unless an impaired capital has been restored. That is why

the Supreme Court stated in *Commissioner v. Phipps*, 336 U. S. 410, 418, that a corporation can have "no accumulated earnings or profits until its actual deficit from prior losses is erased."

This Court has held that Congress intended to ignore this basic principle when it defined a dividend as a distribution from "earnings or profits accumulated after February 28, 1913." This Court has held that Congress intended to tax as income to the recipient a distribution which under well-understood principles of corporation law is universally regarded as a distribution from capital. This Court has also held that Congress had the power to tax such distributions of capital as income within the meaning of the Sixteenth Amendment. We respectfully submit that this Court erred in failing to recognize that distributions made by a corporation with no undistributed current earnings of the taxable year and with an impaired capital are distributions of capital and beyond the power of Congress to tax as income. Our position in this regard is set forth on pages 28-30 of our brief and need not be repeated here.

But we assert that the constitutional question is not reached in this case because we respectfully submit that this Court erred in holding that Congress, when it defined a dividend as a distribution from "earnings or profits accumulated after February 28, 1913," intended to ignore the general principle of corporation law that dividends paid in the face of an operating deficit are regarded as paid from capital. It must be remembered that the reason which impelled Congress to so define a dividend was to eliminate

from the income tax distributions from pre-1913 earnings, which Congress regarded as similar to the stockholder's capital investment in the corporation because his equity in these earnings had been acquired prior to the imposition of the income tax. Is it conceivable that Congress, in adding a phrase to the statute for the purpose of protecting from tax a distribution from *earnings* which it thought should be treated as capital, should have simultaneously intended by the same phrase to subject to tax a distribution from what was unquestionably *capital*? The answer seems obvious. But it is unnecessary to speculate since Congress has specifically recognized the basic principle that unless a corporation has earnings or profits, or an earned surplus, a corporate distribution constitutes a return of capital. This basic principle is clearly expressed in section 201(d) of the Act of 1924, the pertinent portion of which reads as follows:

“(d) If any distribution (not in partial or complete liquidation) made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, *and is not out of earnings or profits*, then the amount of such distribution shall be applied against and reduce the basis of the stock provided in section 204, and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property.

* * *” (Italics added.)

Thus any distribution which is not out of earnings or profits must be applied against and reduce the basis of the stock and if it exceeds the basis the excess is to be taxed as a gain on the sale of property. Here is a clear

recognition that earnings or profits are essential to the declaration of a taxable dividend. If there are no earnings or profits at the time of a corporate distribution then the distribution is not a dividend but is applied against the basis of the stock. The reason the distribution is applied against the basis of the stock is that the *source* of the dividend, there being no earnings or profits, must of necessity be capital. Thus the Congressional Committee Reports of both the House and the Senate in referring to this section of the Revenue Act of 1924 state:

“This subdivision provides that amounts distributed by a corporation *which do not constitute distributions of earnings or profits* or increase in value of property accrued prior to March 1, 1913 (such as distributions out of unrealized appreciation in value of property or out of depreciation or depletion reserves) *constitute a return of capital* to the stockholder and are taxable to him only if, as, and to the extent that they exceed the basis of his stock.” (Italics added.)

Section 201(d) of the 1924 Act was repeated in identically the same form in the Act of 1926 and as section 115(d) in the Acts of 1928, 1932 and 1934. Thus during the period 1924 to 1935, both inclusive, covering five major Revenue Acts, the existence of earnings or profits, in other words, an earned surplus, was an essential prerequisite to the declaration of a taxable dividend. These Revenue Acts, therefore, conform to the general principle of corporation law that dividends paid in the face of an operating deficit are distributions of capital. It is clear beyond argument that during this period at least a distribution made by a

corporation with no earnings or profits is not a dividend and cannot be taxed as income to the recipient. And yet the Commissioner states in his reply brief (page 10) that "There never has been a time when such a distribution (by Oceanic) would not have been taxed as a dividend to the distributees."

This statement is obviously erroneous. But the Commissioner has been forced to contend that a distribution made by Oceanic under any of the Revenue Acts of 1924, 1926, 1928, 1932 and 1934 would have been taxable to the recipients as a dividend. The Commissioner was faced with the necessity of choosing either of two arguments—(1) he could contend that the words defining a dividend in the five major Revenue Acts during the years 1924 to 1935, both inclusive, had changed their meaning in later acts although Congress repeated the identical words without change, or (2) he could contend that under these five major acts the existence of earnings or profits, in other words an earned surplus, was *not* an essential prerequisite to the declaration of a taxable dividend. He chose the second alternative. The Commissioner has thus recognized that the meaning of the statutory definition of a dividend under these Acts is the crux of this case.

The Commissioner's argument on this point is set forth on pages 5 to 10 of his reply brief. It is based upon a comparison of section 201(c) of the 1921 Act with the corresponding section 201(d) of the 1924 Act. The 1921 Act provided that if a distribution was not out of "(1) earnings or profits accumulated since February 28, 1913, or (2) earnings or profits accumulated * * * prior to

March 1, 1913" then it would be applied against and reduce the basis of the stock.³ The 1924 Act changed the quoted words to the simpler expression "earnings or profits." The Commissioner first argues that the words "earnings or profits" in the 1924 Act should be interpreted as though no change had been made from the corresponding section of the 1921 Act, i.e., as though they read "earnings or profits accumulated since February 28, 1913, or earnings or profits accumulated prior to March 1, 1913." The Commissioner then assumes that under the language of the 1921 Act Congress intended that the accumulated earnings or profits should be determined for each period *without regard to an impairment of capital*. Thus the basic assumption of the Commissioner's argument is the very question at issue. Certainly if Congress had intended that accumulated earnings or profits should be separately computed for the periods before and after 1913 and without regard to an impairment of capital it would not have changed the phrases used in the 1921 Act to the words "earnings or profits." Nor would the Congressional Committee Reports quoted above (p. 6), in explaining this section of the 1924 Act, have stated that "This subdivision provides that amounts distributed by a corporation *which do not constitute distributions of earnings or profits* * * * *constitute a return of capital*." Certainly the words "earnings or profits" in the Committee Reports cannot be interpreted as though they meant earnings or profits for two different periods separately computed.

³The acts prior to the 1921 Act did not contain any section corresponding to section 201(c) of the 1921 Act.

There is therefore no merit to the Commissioner's attempt to answer our argument. Our point is simply that section 201(d) of the 1924 Act, in providing that if a distribution is not out of earnings or profits it must be applied to reduce the basis of the stock, coupled with the Committee Reports stating that such a distribution is a distribution of capital, makes it clear beyond any possibility of doubt that earnings or profits, or an earned surplus, are an essential prerequisite to the declaration of a taxable dividend. Further, we submit that Congress at no time intended otherwise, and that earnings or profits, or an earned surplus, always were an essential prerequisite to the declaration of a taxable dividend. If under the earlier statutes there was any doubt about this, that doubt was removed by section 201(d) of the 1924 Act.

Since at least under the Acts of 1924, 1926, 1928, 1932 and 1934 it is plain beyond question that earnings or profits, that is to say an earned surplus, are an essential prerequisite to the declaration of a taxable dividend, it follows that under those acts the statutory definition of a dividend must be interpreted so that a distribution made while a corporation has no earnings or profits, in other words, while its capital is impaired, does not come within the definition. Since the statutory definition of a dividend has remained unchanged (with the exception of an addition which the Commissioner does not contend has any bearing upon the problem) and since the identical words cannot possibly have changed their meaning, it follows that the critical words of the statutory definition

of a dividend must be interpreted for the years 1939 and 1940, here involved, in the same manner as under the Acts of 1924, 1926, 1928, 1932 and 1934. For these reasons, and for the further reason that the only answer which the Commissioner has been able to suggest is the obviously erroneous answer that earnings or profits are *not* an essential prerequisite to the declaration of a taxable dividend under the Acts of 1924, 1926, 1928, 1932 and 1934, we respectfully submit and contend that this Court erred in deciding that an impairment of capital existing on March 1, 1913 does not have to be restored before a corporation can have earnings or profits accumulated after February 28, 1913 available for dividends. The statutory definition must be interpreted to mean that there must first be earnings or profits, and secondly that the earnings or profits have been accumulated after February 28, 1913. This is so because a distribution which is not out of earnings or profits is not a dividend.

Wherefore, it is respectfully urged that this petition for a rehearing be granted.

Dated, San Francisco, California,

December 3, 1951.

Respectfully submitted,

LEON DE FREMERY,

MORRISON, HOHFELD, FOERSTER,

SHUMAN & CLARK,

Counsel for Respondents.

CERTIFICATE OF COUNSEL.

I hereby certify that the foregoing petition for rehearing is in my judgment well founded and that said petition is presented in good faith and not interposed for delay.

Dated, San Francisco, California,
December 3, 1951.

LEON DE FREMERY,
Counsel for Respondents.

No. 12,664

IN THE

United States Court of Appeals
For the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

GRACE H. KELHAM, LEILA H. NEILL, ELLIS
M. MOORE, HARRIET H. BELCHER and
LILLIE S. WEGEFORTH,
Respondents.

BRIEF OF AMICUS CURIAE IN SUPPORT OF
RESPONDENTS' PETITION FOR A REHEARING.

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in No. 12,657, and for Spreckels-
Rosekrans Investment Company,
John N. Rosekrans and Alma
Spreckels Rosekrans, Respondents
in No. 12,663,*

FILED

DEC - 4 1951

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Respondents.

**BRIEF OF AMICUS CURIAE IN SUPPORT OF
RESPONDENTS' PETITION FOR A REHEARING.**

Pursuant to stipulation and order filed herein on October 26, 1950, counsel for respondents in proceedings Nos. 12,657 and 12,663, file this Brief as Amicus Curiae in support of Respondents' Petition for Rehearing in the above entitled proceeding.*

The Court has reversed the decision of the Tax Court in a brief opinion, which counsel considers completely fails to meet the problem raised by the situation present in these cases. The Court, in effect, holds

*The filing of this brief is not prompted by any disharmony among counsel for the various taxpayers concerned with the disposition of the case, but by a feeling that professional duty calls for a separate presentation of counsel's reaction to the decision reached in the proceeding.

that any distribution of the earnings or profits of a corporation earned after February 28, 1913, is gross income to the recipient.

It may well seem, on first impression, that the question is simple and that respondents and thirteen of the sixteen members of the Tax Court have missed the simple solution and unnecessarily involved the question. Counsel believes, however, that the solution is not so apparent as the Court assumes and that the cases warrant further consideration by this Court.

The question whether a distribution of current earnings constitutes gross income was expressly and intentionally withdrawn from the cases by the stipulation of facts in the Tax Court and all such distributions, pursuant to that stipulation, were found taxable by the judgment of that Court. (Transcript pages 42 and 43.) As a result, the sole question to be considered and answered in this proceeding is whether undistributed earnings of one year can be regarded as having been *accumulated* in the face of a deficit in paid-in capital, so that a distribution in a subsequent year in excess of the current earnings of such subsequent year constitutes gross income in the hands of a recipient thereof.

The Court apparently feels that it has justified its conclusion that such non-current earnings are "accumulated" earnings, notwithstanding the existence of a deficit in paid-in capital, when it states on page 3 of the opinion:

"Congress drew a line between February 28, 1913, and March 1, 1913."

This statement ignores the conclusion of the Supreme Court in *Helvering v. Canfield* (1933), 291 U.S. 163, that no such impenetrable line was drawn by Congress. The Supreme Court says (291 U.S. 167):

“The fundamental contention of the taxpayers is that the statute created two distinct periods for tax purposes; that the accumulations for each period constituted ‘a fixed and static amount, not to be changed by happenings after the end of the period.’ That the statute does relate to two periods, the dividing line being March 1, 1913, and that the periods are distinct, is obvious. But it does not follow because there are two distinct periods that the accumulations for each period constitute ‘a fixed and static amount’ and are to remain unaffected despite the vicissitudes of business.”

The Supreme Court had just previously stated in its opinion:

“* * * *We are not here concerned with capital in the sense of fixed or paid-in capital, which is not to be impaired, or with the restoration of such capital where there has been impairment. No case of impairment of capital is presented.*” (Italics supplied.)

It therefore is necessary for this Court to consider the fact that there had been an impairment of the paid-in capital of the Spreckels Company at the time the distributions to stockholders were made and, likewise, to consider the effect of such impairment on the earnings and profits of the Company.

It is obvious the Supreme Court did not intend by its decision in the *Canfield* case to foreclose a consideration of the effect on corporate earnings of the right of a corporation to restore an impairment of its paid-in capital, since the Court had only a few years previously, in *Willcuts v. Marion Dairy Company* (1927), 275 U.S. 215, a case involving the determination of invested capital for excess profits tax purposes, held (275 U.S. 218):

“* * * But it is a prerequisite to the existence of ‘undivided profits’ as well as a ‘surplus,’ that the net assets of the corporation exceed the capital stock. Hence, where the capital is impaired, profits, *though earned and remaining in the business*, if insufficient to offset this impairment do not constitute ‘undivided profits.’” (Italics supplied.)

It follows that this Court in adopting the reasoning of the dissenting opinion in the Tax Court, has undertaken to read into the Revenue Acts an intention on the part of Congress to subject to taxation, as a distribution of corporate income, a classification of receipts of the corporation which the Supreme Court refuses to recognize as surplus or profits.

By this interpretation of the Revenue Act, the Court has raised, but failed to consider or answer the question as to whether, as contended in Respondents’ Brief, page 29:

“* * * section 115(a) of the Internal Revenue Code is unconstitutional if it is construed to im-

pose an income tax upon distributions which are in excess of current earnings and where the corporation has no accumulated earnings or profits.”

A distribution of capital is not taxable under the Sixteenth Amendment and hence the result of the present decision will be to confirm an attempted levy on capital without apportionment among the several states as required by Section 2 of Article I of the Constitution of the United States.

The Respondents in proceedings Nos. 12,657 and 12,663, represented by counsel appearing *amicus curiae*, who have stipulated that their proceedings abide the event of the decision in this proceeding, request that Respondents’ Petition for a Rehearing be granted in order that this Court may consider further the application of the *Canfield* and *Willcuts* cases and the constitutional question now fully presented by the reversal of the Tax Court.

Dated, San Francisco, California,
December 3, 1951.

Respectfully submitted,

WALTER SLACK,

Amicus Curiae, Counsel for Alma de Bretteville Spreckels, Respondent in No. 12,657, and for Spreckels-Rosekrans Investment Company, John N. Rosekrans and Alma Spreckels Rosekrans, Respondents in No. 12,663,

CERTIFICATE.

The undersigned hereby certifies that in his judgment respondents' petition for a rehearing is well founded and that it is not interposed for delay.

Dated, San Francisco, California,
December 3, 1951.

WALTER SLACK,
Amicus Curiae.



No. 12,664

IN THE

United States
Court of Appeals

For the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

VS.

GRACE H. KELHAM, LEILA H. NEILL, ELLIS
M. MOORE, HARRIET H. BELCHER, and
LILLIE S. WEGEFORTH,
Respondents.

Brief in Support of Respondents' Petition
for Rehearing

On Behalf of Adolph B. Spreckels and Dorothy C. Spreckels, Taxpayers and
Respondents in Commissioner of Internal Revenue, Petitioner, v.
Adolph B. Spreckels, et al., Respondents, No. 12,663.

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FILED

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PAUL P. O'BRIEN

CLERK

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TABLE OF AUTHORITIES CITED

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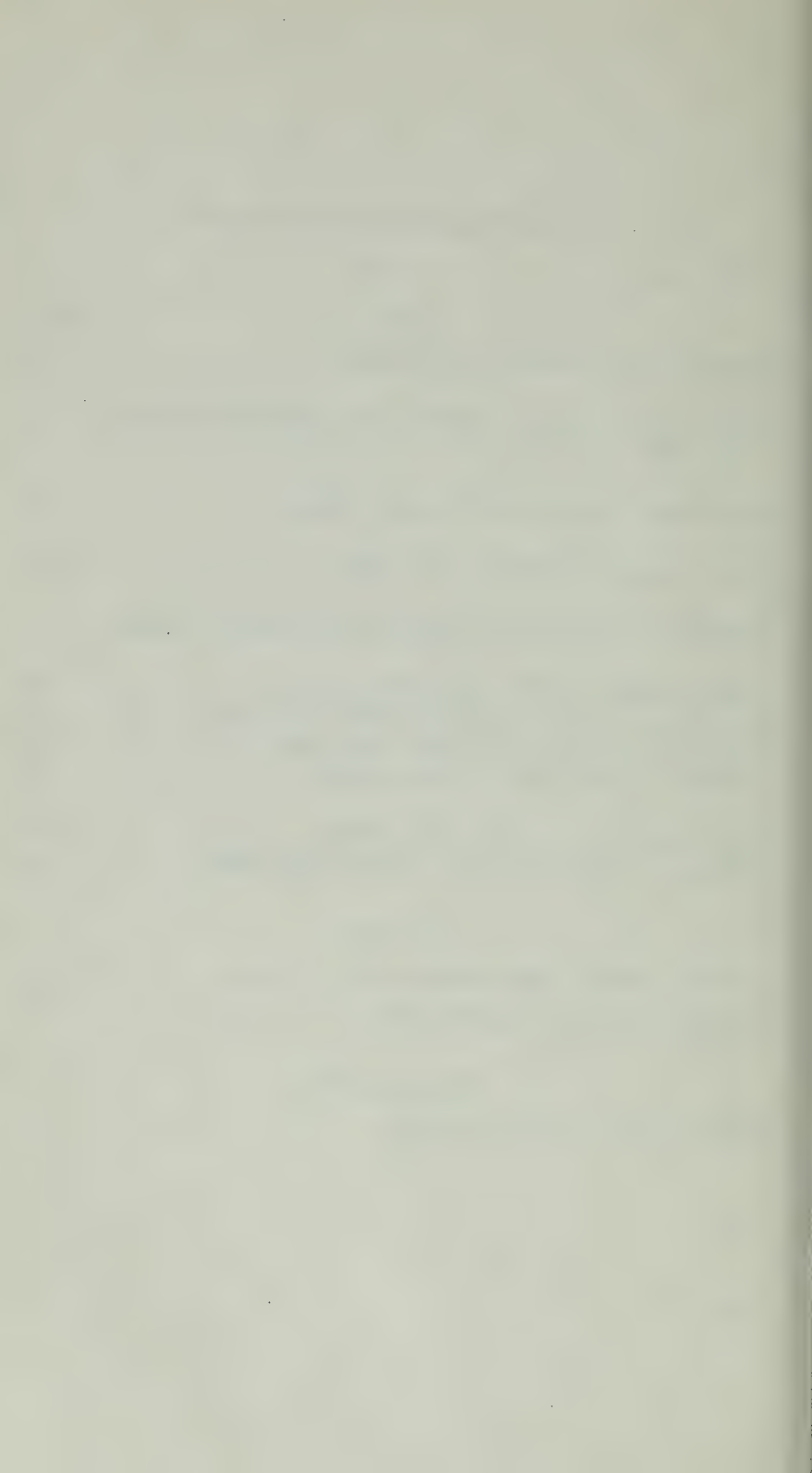
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On Behalf of Adolph B. Spreckels and Dorothy C. Spreckels, Taxpayers and
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Adolph B. Spreckels, et al., Respondents, No. 12,663.

By stipulation entered into between counsel and approved by this Court on October 25, 1950, it was stipulated that counsel for respondents in the *Spreckels'* case above mentioned (No. 12,663) should have the privilege of filing a brief, either as amicus curiae or on behalf of said respondents, in the entitled proceeding. Accordingly, this brief is now presented in support of the Petition for Rehearing filed by respondents herein.

It is respectfully submitted that the Court, in its opinion dated November 5, 1951, in effect begs the question presented in this case, and fails to consider and be guided by the Supreme Court's opinion in *Helvering v. Canfield*, 291 U.S. 163 (1934).

I.

The question presented to the Court was whether or not certain corporate distributions were taxable income to the recipients within the meaning of Section 115(a)(1) of the Internal Revenue Code.

The Court summarizes its thinking in the last paragraph of its opinion, saying

“* * * The present statute is here construed in the light of its language and the broad purpose to tax all *income*. That taxpayers should escape the common burden of taxation, which falls on the just and unjust alike on *income* currently received, simply because the corporation which made the distribution from current earnings had losses over thirty-five years ago, before the Constitution permitted unapportioned taxation of income, is inconceivable.” (Emphasis added.)

If the distributions concerned were *income*, it would indeed be inconceivable that the respondents should escape taxation thereon. But the question itself is whether the distributions were or were not income.

The Court has confused the character of the money involved in the hands of the corporation with its character in the hands of the stockholder-respondents. The Court presents as an illustration the example of an individual insolvent as of February 28, 1913; such individual is of course analogous to the corporation. It goes on to note that “after

* * * [February 28, 1913], taxation of all sums received as income was possible," and that "the power to tax" and "the intention to burden" all income after that date is incontrovertible. Finally, it quotes from the dissenting opinion of the court below, that

"Since the money here involved as distributed to stockholders was in fact earned by the corporation since February 28, 1913, it is to be presumed that Congress, intending to use its taxing power to the fullest extent, intended to tax such funds."

All of the foregoing apply to the situation of the corporation, about which there is no argument. No one would deny that the corporation is taxable on its earnings after February 28, 1913, regardless of its having had a deficit on that date. But to say that what is income to the corporation is income to the stockholders, and that Congress intended the double taxation of such funds, is a different matter, and one that the Court fails to meet squarely. On the contrary, although admitting that what the respondents actually received was capital to them, the Court bases its opinion entirely on the assumption that they received taxable income, the very question at issue.

In making such an assumption, the Court has ignored or dismissed without any consideration the many cases holding that distributions of a corporation made in the face of an operating deficit incurred after February 28, 1913, must be regarded as capital return to the distributee and not income.* The Court mentions that "this is a plausible inter-

**Foley Securities Corp. v. Commissioner*, 106 F.2d 731 (C.C.A. 8th, 1939); *Crystal Ice Co.*, 14 B.T.A. 682 (1928); *J. L. Washburn*, 16 B.T.A. 1091 (1929); *Louise Glaswell Shorb*, 22 B.T.A. 644 (1931); *Arthur C. Stifel*, 29 B.T.A. 1145 (1934); *Roy J. Kinnear*,

pretation" "for corporations organized since March 1, 1913," but in fact the rule of these cases is not so confined, and several of the corporations involved had corporate life prior to that date.†

Moreover, the holding of the Court must result in taxing respondents on receipt of capital, and if Section 115(a)(1) of the Internal Revenue Code is so construed, it is in violation of Section 2 of Article I of the Constitution of the United States, for levying a direct tax not apportioned among the several states. *Pollock v. Farmers Loan & Trust Co.*, 157 U.S. 429 (1895). It does not appear from the Court's opinion that the Court gave any consideration to the constitutional question, a failure probably occasioned by its adoption of the erroneous assumption described above.

II.

In holding that the corporate distributions in question constituted taxable income, the Court has failed to follow the reasoning of the Supreme Court in *Helvering v. Canfield*, *supra*, and has apparently not given due consideration to the case (it is mentioned only in a footnote without discussion).

36 B.T.A. 153 (1937); *Shellabarger Grain Products Co.*, 2 T.C. 75 (1943). See also *Loren D. Sale*, 35 B.T.A. 938 (1937); G.C.M. 1552, VI-1 C.B. 10 (1927). Cf. *Willcuts v. Milton Dairy Co.*, 275 U.S. 215 (1927), holding that there can be no earned surplus or undivided profits until any deficit or impairment of a corporation's capital has been made good.

†See the *Crystal Ice Co.*, *Washburn* and *Kinnear* cases, *supra*. The rule is stated in the *Kinnear* case as follows:

"The rule is that a corporation does not have earnings or profits available for distribution as dividends until impairments of capital or paid-in surplus resulting from operating losses have been restored."

In that case, the taxpayer-stockholders contended that Congress had drawn a line between February 28 and March 1, 1913, and that their corporation's surplus as of that date could therefore be disregarded, and its later deficits be used to offset its later earnings (under the rule of the *Crystal Ice Co.* and other cases, *supra*), to the end that it would be said to have no "accumulated earnings" within the meaning of the statute.*

But the Supreme Court refused to draw such a line. Instead the Court decided that in order to determine the character of corporate distributions, the entire life history of the corporation must be taken into account. It found that the stockholders of the corporation involved did indeed receive income, because their corporation's post-1913 losses were offset by its pre-1913 surplus. Surely the same court, looking at the converse situation in the instant case, would again refuse to draw a February 28-March 1, 1913, line, and would find no accumulated earnings in the Spreckels Company at the time in question.

The holding of the *Canfield* case forces the conclusion that the term "accumulated" refers back to the inception of corporate life to commence building the "accumulation." In effect, the Supreme Court held that the language "* * * (1) out of its earnings or profits accumulated after February 28, 1913 * * *" in Section 115(a)(1) must be interpreted to read "* * * (1) out of its earnings or profits accumulated from the date of incorporation, provided that those accumulated prior to March 1, 1913, shall not be included therein

*Section 201(a) of the Revenue Act of 1921, substantially the same as Section 115(a)(1) of the Internal Revenue Code, involved in the instant case.

to the extent that they are intact at the time of such distribution * * *

Applying the statute in such form to the instant case would leave no argument that the distributions to the Spreckels' stockholders could be considered pro tanto taxable dividends, since there would not be, to the extent described in the stipulation of facts, any accumulated earnings or profits. It is therefore submitted that the Court's holding herein is in conflict with the Supreme Court's interpretation of the statute in the *Canfield* case.

For the foregoing reasons, it is urged that respondents' Petition for Rehearing be granted.

Respectfully submitted,

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Dated: December 4, 1951



